The Rise and Fall (?) of Shareholder Activism by Hedge Funds

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This paper draws heavily on "The Market for Corporate Influence: Activist Hedge Funds and their Antecedents", a paper given at the Activist Investors, Hedge Funds and Corporate Governance Conference in Amsterdam in March 2007. We are grateful for feedback for feedback received at the conference and at seminars held at Harvard Business School, Vanderbilt Law School, the University of Virginia Law School and Wharton Business School.

Abstract

Shareholder activism by hedge funds has over the past few years become a major corporate governance phenomenon. This paper puts the trend into context. The paper begins by distinguishing the "offensive" form of activism hedge funds engage in from "defensive" interventions "mainstream" institutional investors (e.g. pension funds or mutual funds) undertake. Variables influencing the prevalence of offensive shareholder activism are then identified using a heuristic device we call "the market for corporate influence". The rise of hedge funds as practitioners of offensive shareholder activism is traced by reference to the "supply" and "demand" sides of this market, with the basic chronology being that, while there were direct antecedents of hedge fund activists as far back as the 1980s, hedge funds did not move to the activism forefront until the 2000s. The paper brings matters up-to-date by discussing the impact of the recent financial crisis on hedge fund-driven shareholder activism and draws upon the market for corporate influence heuristic to predict future trends.

Keywords: Shareholder activism, hedge funds, financial crisis.

JEL Classifications: G34, G38, K22, N22

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INTRODUCTION

The brand of shareholder activism associated with hedge funds became a major corporate governance phenomenon in the mid-2000s. Jonathan Macey, a Yale Law School academic, argued in 2008 that hedge funds, together with private equity, "are the newest big thing in corporate governance and are likely to remain an important and controversial feature of the legal and financial landscape for some time to come."[1] Financial economists and law professors responded promptly to the challenge posed, as the surge in shareholder activism by hedge funds prompted a series of papers on the phenomenon. These papers addressed various important questions concerning hedge fund activism such as "Which public companies are targeted?"[2] "What changes do hedge funds seek to promote?"[3] "Do they achieve their stated objectives?"[4] "What is the time horizon of hedge funds that engage in shareholder activism?"[5] "Does hedge fund activism improve the share price performance of targets?"[6] "Do hedge funds have a counterproductive self-serving agenda – a "dark side" that necessitates a regulatory response?"[7]

While academics responded expeditiously to the rise of hedge fund-driven shareholder activism and have provided valuable evidence on key aspects of the phenomenon, the relevant literature glosses over various important contextual questions. For instance, what distinguishes the particular form of activism hedge funds have engaged in from that undertaken by "mainstream" institutional investors, such as pension funds or mutual funds? What motivates investors to step forward in the manner hedge funds have done? In other words, given that activism is costly, in terms of time, effort and diversification forsaken, how is it that at least for some investors the perceived benefits outweigh the costs? Why did activism by hedge funds achieve prominence in the 2000s? Was hedge fund activism prevalent before then? If not, why not? And how accurate is Macey's forecast that hedge fund activism is likely to remain an important part of the corporate governance landscape for some time to come?

This paper puts the recent surge of hedge fund-driven shareholder activism into context by addressing these important background questions. Part I is definitional in orientation, as it identifies the key characteristics of the form of shareholder activism in which hedge funds engage. It explains what is distinctive about the operations of hedge funds in the shareholder activism context by distinguishing between "offensive" and "defensive" interventions, indicating that hedge funds engage in the former while other shareholders tend only to engage in the latter, in the sense they will only step forward to protect or enhance the value of pre-existing holdings. Part I also explains how offensive shareholder activism differs from interventions designed to achieve full voting control, doing so by introducing the heuristic of a "market for corporate influence" oriented around the purchase of blocks of shares where the intention is to bring pressure to bear on management without obtaining a majority stake.

Part II of the paper identifies "demand" and "supply" factors that shape the market for corporate influence and is so doing outlines the variables likely to determine levels of offensive shareholder

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[1] Jonathan Macey, *Corporate Governance: Promises Kept, Promises Broken* (Princeton, N.J.: Princeton University Press, 2008), 241.

[2] William W. Bratton, "Hedge Funds and Governance Targets", (2007) 95 Georgetown L.J. 1375, 1390-1401; Alon Brav, Wei Jiang, Frank Partnoy and Randall Thomas, "Hedge Fund Activism, Corporate Governance and Firm Performance", (2008) 68 J. Fin. 1729, 1749-55; April Klein and Emanuel Zur, "Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors", (2009), unpublished working paper, at 18-24 (available at http://www.afajof.org/afa/forthcoming/4442.pdf).

[3] Brav *et al., supra* note 2, 1741-44; Klein and Zur, *supra* note 2, 30-31, Table 6.

[4] Bratton, *supra* note 2, 1405-9; Brav *et al., supra* note 2, 1744-45; Klein and Zur, *supra* note 2, 28-34.

[5] Bratton, *supra* note 2, 1410-13; Brav *et al., supra* note 2, 1746-49.

[6] Bratton, *supra* note 2, 1418-22; Brav *et al., supra* note 2, 1760-63; Klein and Zur, *supra* note 2, 24-27, 34-44.

[7] Marcel Kahan and Edward B. Rock, "Hedge Funds in Corporate Governance and Corporate Control", (2007) 155 U. Pa. L. Rev. 1021.

activism over time. Part III describes the emergence of hedge funds as the dominant practitioners of offensive shareholder activism in U.S. corporate governance. It identifies antecedents from the 1980s and 1990s but emphasizes hedge funds did not move to the forefront until the 2000s. Part IV draws upon Part II's assessment of the costs and benefits of offensive shareholder activism to explain why hedge funds stepped forward when they did. Part V brings the story up-to-date and discusses future trends in offensive shareholder activism, indicating that while the decline in share prices associated with the 2008 financial crisis expanded considerably the number of "undervalued" companies that could be targeted, market conditions and regulation will likely combine to restrict at least partially the scope hedge funds have to respond. Part VI concludes.

I. DEFINITIONAL ISSUES

A. What is Shareholder Activism, Hedge Fund-style?

Shareholder activism has been described as "the exercise and enforcement of rights by minority shareholders with the objective of enhancing shareholder value over the long term."[8] Defining shareholder activism in this manner presupposes that intervention will be undertaken with shareholder rights as the departure point. Correspondingly, investors— including hedge funds—that focus on fixed income products do not qualify as shareholder activists, meaning the distressed debt investing carried out by "vulture investors" does not qualify as shareholder activism.

"Vultures" target companies in severe financial difficulties and acquire debt issued by such firms at a steep discount, reflecting the high likelihood of default.[9] Vulture funds anticipate they can generate returns for their end-investors by adopting a tough negotiating posture, typically backed by credible threats to use legal recourse to seize control of the troubled firm.[10] While hedge funds operating as "vultures" are certainly "activist" in orientation, they are not *shareholder* activists because they rely on debt, rather than equity, positions as their departure point.

While defining shareholder activism by reference to the use of shareholder rights to enhance shareholder value delineates the basic parameters of this corporate governance tactic, the formulation is too general in nature to distinguish hedge fund interventions from those carried out by "traditional" institutional investors such as mutual funds and public pension funds. Kahan and Rock have described the different approaches adopted as follows:

> "Mutual fund and public pension fund activism, if it occurs, tends to be incidental and ex post: when fund management notes that portfolio companies are underperforming, or that their governance regime is deficient, they will sometimes be active (footnote omitted). In contrast, hedge fund activism is strategic and ex ante: hedge fund managers first determine whether a company would benefit from activism, then take a position and become active."[11]

Or as Macey has put it, while "(m)utual funds and other savvy investors" generally will decline to invest in poorly performing companies, "rather than seeing bad performance as something to avoid, hedge funds…see investment opportunities."[12] Employing the adjectives "defensive" and "offensive" provides a convenient way to distinguish the sort of activism in which traditional institutional shareholders engage from the sort for which hedge funds have achieved notoriety.

Defensive shareholder activism occurs when an investor with a pre-existing stake in a company

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[8] Chee Keong Low, "A Road Map for Corporate Governance in East Asia", (2004) 25 Nw. J. Int'l. Bus. Law 165, 185-86.

[9] See Edith S. Hotchkiss and Robert M. Mooradian, "Vulture Investors and the Market for Control of Distressed Firms", (1997) 43 J. Fin. Econ. 401.

[10] Thomas H. Noe and Michael J. Rebello, "Reputation and the Market for Distressed Firm Debt", (2003) 38 J. Fin. Quantitative Analysis 503, 504-5; Mike Spector and Jeffrey McCracken, "Distressed Takeovers Soar", Wall St. J., Aug. 11, 2009.

[11] Kahan and Rock, *supra* note 7, 1069.

[12] Macey, *supra* note 1, 247.

becomes dissatisfied with corporate performance or corporate governance and reacts by lobbying for changes, whether "behind the scenes" or with a public challenge to management (e.g. proposing the election of directors the dissidents support). A shareholder acting in this sort of defensive manner will not own enough shares to secure boardroom control or dictate corporate policy, but will be able to use their stake as an important departure point in garnering support for the changes they advocate. To the extent pension funds and mutual funds engage in shareholder activism, it will most often be of this sort, working "defensively" to protect existing investments in the targeted company.

Defensive shareholder activism is by no means limited to interventions by institutional investors. Instead, the label is apt whenever an investor who owns a sizeable stake in a company subsequently relies on shareholder rights to take rearguard corrective action. An example is John D. Rockefeller, who organized a successful proxy fight at Standard Oil of Indiana in 1929.[13] After Colonel Robert Stewart, the chairman of the company, became implicated in the Teapot Dome political scandal, Rockefeller urged him to resign. Stewart refused. Rockefeller, who owned 15% of the shares, launched a proxy fight in which he put forward an insurgent slate of directors challenging those backed by Stewart and the rest of the management team. Rockefeller, who had the support of Standard Oil's bankers and various institutional shareholders, prevailed in a hotly contested vote.

The key feature that makes activism "defensive" is that the shareholder will have held a sizeable stake before stepping forward, the value of which the investor is seeking to protect through intervention. This "initial endowment" is not a feature of what we term "offensive" shareholder activism. What happens here is that an investor lacking a meaningful stake in a company builds up one "offensively" on the presumption that changes will be made to correct failures to maximize shareholder returns and with the intention of agitating for change if management does not take the initiative. As the quotes from Kahan and Rock and from Macey indicate, this is precisely the sort of activism for which hedge funds have gained notoriety.

The term "offensive shareholder activism" potentially connotes an aggressive posture towards incumbent management. However, this corporate governance tactic does not necessarily imply a strongly confrontational attitude towards those running a target company. For instance, Hunt Foods, a publicly traded company led by Norton Simon that engaged in "offensive" activism in the 1950s and 1960s, was fully prepared to cooperate with management in companies in which it established a sizeable stock position. As Simon said in a 1965 interview, "The more management works with us, the less likely we'll go any further."[14]

Similarly, while hedge funds activists have gained notoriety for a confrontational posture, they often aim for a collegial if firmly "hands on" approach with incumbent management.[15] As Warren Lichenstein, the founder of Steel Partners II, a prominent activist hedge fund,[16] said in 2004, "The best situation is where we find a cheap stock with great management and a great business, and we can sit back and make money." Correspondingly, Lichenstein found when Steel Partners II bought shares, "Many times managements are happy there's a long-term supportive investor."[17]

Lichenstein's reference to the desirable properties of a "cheap stock" reveals an overlap in investment philosophies between activist hedge funds and the prototypical "value investor" who seeks through diligent analysis of corporate fundamentals to purchase shares trading at a bargain price, the proverbial dollar for 50 cents.[18] Hedge funds that engage in offensive shareholder activism typically

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[13] Carter F. Henderson and Albert C. Lasher, *20 Million Careless Capitalists* (Garden City, N.Y.: Doubleday & Co., 1967), 75-77.

[14] David C. Smith, "Not-So-Simple Simon", Wall Street J., March 4, 1965, 1.

[15] "Proxy Warriors", Institutional Investor, January 2003.

[16] In 2009, Steel Partners II was in the midst of converting itself to a public company. See Hedge Fund Solutions, "Steel Partners II Investment Portfolio: Special Report", July 21, 2009.

[17] Stephen Taub, "Man of Steel", *Alpha*, February 2004. See also Helen Avery, "Hedge Funds: Forget Lawyers, Learn from a Real Active Manager", Euromoney, March 2006 (describing the investment philosophy of Tommy Taylor, a veteran hedge fund activist).

[18] Bruce C. N. Greenwald, Judd Kahn, Paul D. Sonkin, Michael Van Biema, *Value Investing: From Graham to Buffett and Beyond* (Hoboken, N.J.: Wiley, 2004), xv.

rely on the "value approach" when identifying targets, forming as such a subset of hedge funds that invests in equities in a manner akin to classic, value-oriented investors.[19] Managers of activist hedge funds correspondingly tend not to be experts in quantitative theories of finance – the typical qualification for a hedge fund manager -- but are often former investment bankers or research analysts used to working hard to understand balance sheets and income statements.[20] Activist hedge funds in turn often justify their investment strategy on the basis the companies they buy stakes in are underperforming and the targets themselves typically have a low share price relative to book value, despite often having sound operating cash flows and returns on assets.[21]

If an activist hedge fund identifies and invests in an "undervalued" company and the share price subsequently increases due to a belated reaction by the market rather than due to any prompting by the hedge fund, this will be relatively "easy money" for the hedge fund. The situation will be the same if management, on its own initiative, makes changes that serve to increase shareholder returns. There is, however, an additional dimension to activist hedge funds, namely a readiness to take a hands-on role to shake things up.[22] Hedge funds, rather than merely adopting the passive approach that characterizes value investing and waiting for the market to self-correct -- which may well never happen if a company's shares do not get noticed and instead drift lower -- are prepared to take the initiative and accelerate matters by lobbying for changes calculated to boost shareholder returns.[23] Hence, despite Lichenstein characterizing Steel Partners as a potentially "supportive investor", activist hedge funds do not give management a full-scale "vote of confidence" when they invest in companies.[24] This serves to distinguish hedge funds from Berkshire-Hathaway, the publicly traded investment holding company legendary value investor Warren Buffett dominates. Berkshire Hathaway has sometimes been labelled an activist investor,[25] but its *modus operandi* differs from that of hedge funds in a fundamental respect.

Berkshire Hathaway owns outright a series of insurance companies that generate the profits Buffett taps to run a large investment portfolio that includes sizeable minority stakes in a handful of carefully selected publicly traded companies.[26] Berkshire Hathaway seeks out companies that are undervalued, in the sense that the intrinsic worth of the company appears to exceed by some margin the current stock price, and then builds up a sizeable stake in the companies that meet its investment criteria.[27] Berkshire Hathaway aims to invest in well-run companies that happen to be out of favour with the market and correspondingly takes a "hands-off" posture with the executives in charge.[28] Indeed, Buffett has been characterized as "one of the most celebrated friends of management in American finance".[29] In contrast, an offensive shareholder activist typically accepts that a target

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[19] Bratton, *supra* note 2, 1383; see also John Authers, "Hoping to Update the Magic Formula", Fin. Times, November 22, 2005, 14 (identifying shareholder activism as the biggest "new idea" in value investing).

[20] Bratton, *supra* note 2, 1383; Lina Saigol, "Hedge Funds are Very Keen to Exercise Their Secretive Shareholding Muscle", Fin. Times, Aug. 9, 2005, 19.

[21] Brav *et al., supra* note 2, 1730, 1752-53. Klein and Zur find likewise that targets of hedge fund activists have low market-to-book ratios but also report the targets have better stock returns than matched sets of companies not targeted: *supra* note 2, 20, 23.

[22] For empirical evidence indicating that activist hedge funds are not merely "stock picking" successfully and profiting thereby, see Brav *et al., supra* note 2, 1763-66.

[23] Bratton, *supra* note 2, 1390; James Altucher, "Why it Pays to Join the Activists", Fin. Times, November 16, 2004, 16.

[24] Macey, *supra* note 1, 248.

[25] *Ibid.*, 270.

[26] On the nature of Berkshire Hathaway, see "Preaching to the Converted", Economist, May 6, 2005.

[27] Warren E. Buffett, "The Essays of Warren Buffett: Lessons for Corporate America" (selected and arranged by Lawrence A. Cunningham), (1997) 19 Cardozo L. Rev. 1, 85.

[28] *Ibid*., 85, 88, 96; Saul Hansell, "Market Place", N.Y. Times, February 21, 1995, D6. Buffett, however, frequently becomes a director of companies that constitute Berkshire's core holdings, and as such will take a hands-on role in the event of a crisis, such as with investment bank Salomon Brothers in 1990. See Buffett, *supra* note 27, 95; Amar Bhide, "The Hidden Costs of Stock Market Liquidity", (1993) 34 J. Fin. Econ. 31, 42.

[29] Anthony Ramirez, "American Express Gets Some Help From Buffett", N.Y. Times, August 2, 1991, D1.

company may not simply be out-of-step with market sentiment but instead may only fulfil its potential as an investment if management, perhaps under activist-induced duress, makes major strategic and/or financial changes.[30] Buffett treats this sort of aggressive investment style with disdain, saying disparagingly of 1980s corporate raiders such as T. Boone Pickens, "They aren't creating value – they are transferring it from society to shareholders."[31]

B. Market for Influence vs. Market for Control

It is also helpful at this stage to distinguish between attempts to use a sizeable minority stake in a public company as a platform to press for change and bids to obtain full voting control.[32] The latter is a key element of the market for corporate control famously identified by Henry Manne.[33] The former – offensive shareholder activism -- can be thought of as underpinning what can be termed a market for corporate *influence*.

Theoretically, a shareholder engaging in offensive shareholder activism can change gears and opt to launch a fully-fledged takeover bid.[34] Likewise, a corporate "raider" who puts target companies on the back foot by acquiring a sizeable stake, criticizing management and intimating a bid for voting control may ensue may never follow through with a genuine tender offer. Hence, seeking influence and seeking control may in principle constitute points on a continuum rather than being fully distinct corporate governance phenomena. However, analytically it is helpful to draw a distinction between investors who intend to agitate for change without acquiring a block of shares sufficiently large to secure legal or *de facto* voting control from those determined to buy up a majority of the shares from existing investors (e.g. by way of a successful tender offer) – labelled by Gilson and Schwartz a "transfer by sale".[35]

Differences between the business models of private equity and activist hedge funds illustrate why it is instructive to distinguish those seeking influence from those seeking control. With the sort of "public-to-private" buyout in which private equity firms specialize voting control is not only obtained but the shares of all public investors are bought out and the company is de-listed from the stock market.[36] Hence, private equity firms focus on "transfers by sale" and, as such, are key players in the market for corporate control rather than the market for corporate influence. To be sure, private equity firms can seek permission from their investors to make "non-control" investments and there are isolated instances where private equity firms engage in activism akin to that carried out by hedge funds.[37] Still, the private equity "bread-and-butter" leveraged buy-out, followed by a going private

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[30] Robert Berner, "The Next Warren Buffett?", Business Week, November 22, 2004, 144; (contrasting Buffett with Eddie Lampert, founder of ESL Holdings, an activist hedge fund discussed *infra* notes 127 to 130 and accompanying text); "The Testing of Long-Term Eddie", Economist, February 2, 2008, 74 (*ditto*).

[31] Steve Fraser, *Wall Street: A Cultural History* (London: Faber and Faber, 2005), 517.

[32] Put more formally, in a voting environment characterized by majority rule, an influential, as opposed to a controlling stake, will be one where the purchaser holds some proportion α (where $0 < \alpha < 1$) of the voting rights, such that $0 < \alpha < 0.5$. With a firm with dispersed stock ownership, it will typically be possible to control the outcome of a vote on most issues with a block less than 50% of the votes. If we take n to represent the fraction of the voting rights necessary to secure a majority vote with certainty (where $0 < n < 0.5$), then we can add an additional constraint, namely that $0 < \alpha < n < 0.5$.

[33] Henry G. Manne, "Mergers and the Market for Corporate Control", (1965) 73 J. Political Econ. 110.

[34] Kahan and Rock, *supra* note 7, 1040.

[35] Ronald J. Gilson and Alan Schwartz, "Sales and Elections as Methods for Transferring Control", (2001) 2 Theoretical Inquiries in Law 783, 790. For a similar exercise in line-drawing, see John Pound, "The Rise of the Political Model of Corporate Governance and Corporate Control", (1993) 68 N.Y.U. L. Rev. 1003, 1007 (distinguishing between "political" and "takeover" models of corporate governance, with the former including "an approach in which active investors seek to change corporate policy by developing voting support from dispersed shareholders, rather than by simply purchasing voting power or control.")

[36] *See* James F. Cotter & Sarah W. Peck, "The Structure of Debt and Active Equity Investors: The Case of the Buyout Specialist", (2001) 59 J. Fin. Econ. 101, 106, 111-12, 143 (acknowledging the pattern but finding a sizeable number of buyouts where private equity firms did not buy up all the shares).

[37] Klein and Zur, *supra* note 2, 14 (reporting that only 9 of the 235 of the investors responsible for

transaction, does not qualify as offensive shareholder activism.

The investment approach activist hedge funds employ is markedly different from that private equity adopts. Private equity firms fully expect to take a "hands on" role with the management of companies they take private, as they anticipate this is how value will be created before the portfolio companies rejoin the stock market or are sold.[38] In contrast, activist hedge funds generally have no interest in obtaining full-scale control of the companies they target.[39] Instead, they prefer not to tie up capital in the form of majority or sole ownership of companies and instead anticipate profiting as minority shareholders when shareholder returns improve, due, if necessary, to changes management makes in response to investor pressure. Hedge fund activists have in some instances put forward a tender offer. Only rarely, though, have they ended up with a majority stake, with the tender offers they make either fading out as an engagement takes its course or being beaten out by a higher bid.[40]

Hedge fund activists typically begin their engagement with target companies by buying up a block of shares in the targeted company and then sounding out management with a telephone call or letter pressing the incumbent board to make changes designed to increase shareholder value.[41] Sometimes hedge funds lobby in favour of increased operational efficiency but the changes they seek are typically finance-oriented, such as having the target improve the balance sheet by spinning off underperforming non-core assets and distribute "excess" cash to shareholders by buying back shares or paying a sizeable one-off dividend.[42] If a quiet approach fails to yield the desired results, an activist hedge fund can step up the pressure, perhaps by criticizing management in public or by threatening a lawsuit against the company's directors.[43] A particularly forceful strategy is to threaten what Gilson and Schwartz term a "transfer by vote", this being the securing of managerial control by winning a proxy contest intended to determine who serves on the board.[44]

Activist investors say they avoid proxy battles if possible because of the high costs involved.[45] Moreover, the preference of hedge fund managers to avoid hands-on involvement in the management of target companies implies that securing board control will typically not be a high priority.[46] Nevertheless, Brav, Jiang, Partnoy and Thomas report that in 13% of instances of hedge fund activism occurring in U.S. public companies between 2001 and 2006 the hedge fund involved launched a proxy contest in order to replace incumbent directors.[47] A possible explanation for the proxy battles that do occur is that hedge funds use contests for board seats to signal to potential future targets that they are prepared to invest heavily in pursuing an activist campaign should this be required.[48]

At least when hedge funds are involved it is appropriate to treat even a wholly successful proxy campaign for directorships as shareholder activism rather than a change of control transaction. When

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"entrepreneurial" activism events occurring in U.S. public companies between 2003 and 2005 were private equity firms).

[38] Brian Cheffins and John Armour, "The Eclipse of Private Equity" (2008) 33 Del. J. Corp. L. 1, 13-14.

[39] Brav *et al.*, *supra* note 2, 1748; Bruce N. Lehmann, "Corporate Governance and Hedge Fund Management", (2006) 91(4) Federal Reserve Bank of Atlanta Econ. Rev. 81, 90.

[40] Bratton, *supra* note 2, 1426-27; Brav *et al.*, *supra* note 2, 1748.

[41] The Conference Board, "Hedge Fund Activism: Findings and Recommendations for Corporations and Investors", (Conference Board, 2008), 43-44.

[42] Klein and Zur, *supra* note 2, 22-23 (citing press reports to this effect and reporting some empirical evidence indicating hedge funds target cash-rich companies).

[43] Conference Board, *supra* note 41, 32, 44; Riva D. Atlas, "Some Funds Taking Role Far Beyond Just Investor", N.Y. Times, August 16, 2005 (but quoting a veteran activist investor to the effect that going public with an attack on the chief executive is "not an activist's first choice").

[44] Gilson and Schwartz, *supra* note 35, 790.

[45] "Winners and Losers in the Rising Tide of the Proxy Wars", Economist Intelligence Unit, August 23, 2008, Executive Briefing, 1.

[46] *Ibid*.

[47] Brav *et al., supra* note 2, 1739, 1743. Klein and Zur's results are virtually identical: *supra* note 2, 32-33, Table VI, Panel B.

[48] This is corroborated by Klein and Zur's finding that "an explicit or implicit proxy threat is positively related to whether an activist successfully gains a seat on the target's board (*supra* note 2, 34)."

hedge funds execute a transfer by vote, the intent typically will be to use board control merely to orchestrate the short- to medium-term changes the hedge fund anticipates will boost shareholder returns. Again, obtaining enduring voting control through ownership of shares will rarely, if ever, be part of the plan. In contrast, with a transfer by sale, success is defined by whether the bidder acquires a sufficiently large equity stake to guarantee the outcome of shareholder votes, including those that determine who serves on the board. A successful takeover bidder correspondingly has to back up any plans it might have to change the company with financial clout unnecessary for a hedge fund merely securing a transfer by vote.

While activist hedge funds rarely seek to precipitate a change in voting control of target companies, there are hedge funds that play a key role in the market for corporate control by engaging in "risk arbitrage", also known as merger arbitrage. Risk arbitrage is a form of speculation on merger deals, occurring in its most straightforward form when an investor in essence bets a deal will go through by purchasing the shares of a target company if they are trading at a discount to the offer price due to other investors anticipating the deal will fall apart. Variations include shorting the shares of an acquirer on the assumption its shares will drop in price if the merger closes and shorting shares of the target on the assumption the merger will not be finalized.[49]

When a large proportion of a company's stock is concentrated in the hands of risk arbitrageurs ("arbs"), they may well lobby management and work the media to obtain results that serve their interests.[50] In this sense, arbs can resemble investors who engage in offensive shareholder activism. On the other hand, there is a key difference with respect to timing. Arbs most often only commence their buying and short selling operations after a prospective deal is announced or after disclosure that a likely bidder has taken a sizeable stake.[51] Hence, risk arbitrage is "event-driven", with a potential M&A transaction being the trigger. In contrast, offensive shareholder activists drive events. There is unlikely to be any specific catalyst for the insurgent to begin stake-building or agitating for change. Instead, it falls to the activist shareholder to make the first move.

II. Elements of the Market for Corporate Influence

Having distinguished offensive shareholder activism from other forms of investor involvement in corporate affairs, we now articulate a simple model that clarifies when adoption of this strategy is likely to be worthwhile. We then use the market for corporate influence as a heuristic to identify factors likely to dictate how commonplace offensive shareholder activism will be at a particular point in time.

A. When is Offensive Shareholder Activism a Rational Strategy?

1. A Simple Model

For insurgents to step forward and engage in offensive shareholder activism, they must anticipate that the benefits they will derive will outweigh their costs. However, while activist shareholders typically must bear all the costs associated with intervention, due to the fact they will have only a minority stake in the companies they target, they will receive only a fraction of the improvements in shareholder return their efforts generate. This is a potentially powerful deterrent to offensive

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[49] See http://moneyterms.co.uk/risk-arbitrage/ (last visited Dec. 3, 2008); Bruce Wasserstein, *Big Deal: 2000 and Beyond* (New York: Time Warner, 2000), 572.

[50] Wasserstein, *supra* note 49, 572.

[51] *Ibid.*; Fredrick B. Henry, "The Activities of Arbitrageurs in Tender Offers", (1970-71) 119 U. Pa. L. Rev. 466, 474; Robert J. Cole, "Arbitragers Face the Spotlight", N.Y. Times, November 17, 1986, D1 (quoting the managing partner of a big arb player as saying "What we do for the most part is commit capital to the stocks of companies that announce corporate deals….We don't involve ourself *(sic*) in rumors….", but acknowledging that during a mid-1980s takeover frenzy some arbitragers were betting on which companies were likely to be the next takeover target).

shareholder activism. Put more formally, if we denote the expected costs of exercising influence to improve shareholder returns at a target company as c_i, the expected benefits for the firm's shareholders from exercise of influence as b_i, and the proportion of the target firm's shares held by the insurgent as α, (where $0 < \alpha < 1$), then the exercise of influence will be privately rational for the insurgent only if the following inequality is satisfied:

$$c_i < \alpha\, b_i \qquad (1)$$

Before considering the elements of this inequality in more detail, an important caveat concerning our analysis is in order. This is that we do not take into account the interaction between the market for corporate influence and the market for corporate control. A transfer by sale, to use Gilson and Schwartz's terminology, permits an investor to internalize the full benefits of any change in corporate performance, rather than, as with shareholder activism, conferring a positive externality on other shareholders.[52] One might therefore wonder why influence-based shareholder activism is observed at all. To do proper justice to this point would require a thorough comparative analysis of takeover bids and shareholder activism,[53] and we intend in future research to explore how the development of the market for corporate control impacted historically upon the market for corporate influence. However, given that we are currently focusing on the phenomenon of hedge fund activism and hedge funds rarely seek to obtain full-scale voting control in their targets, we will treat this important theoretical detour as beyond the scope of our present enquiry.

2. Costs Associated with Exercising Influence

The costs associated with exercising influence (c_i) include search costs, transaction costs and financing costs. Search costs arise because an investor intent on engaging in offensive shareholder activism will have to identify and investigate appropriate target companies. As and when a suitable target is found and an activist campaign is launched, various types of transaction costs will arise, such as expenses related to the acquisition of shares (e.g. brokers' commissions and the bid-ask spread) and expenditures associated with the activist engagement itself. Transaction costs therefore encompass what can be termed "communication costs", which will include, if a proxy contest is on the cards, advertising expenses, charges involved with making required filings with securities regulators, outlays associated with the distribution of proxy materials to shareholders and fees payable to proxy contest advisers such as investment bankers, lawyers and proxy solicitors.[54] The figures involved can mount up quickly. For instance, Red Zone LLC, the investment vehicle Daniel Snyder used to build up an 11.7% stake in theme park operator Six Flags, spent $11.6 million in 2005/06 to persuade shareholders to hand managerial control over to Snyder and his team.[55] While successful activist shareholders can sometimes recover from the target corporation expenses they incur in a proxy contest, they frequently will not be able to do so, meaning they have to foot the full bill.[56]

Financing costs necessarily constitute a constraint with most instances of offensive shareholder activism because potential activists will usually not be rich enough themselves to buy up a significant stake in a public company, at least one traded on a major stock exchange.[57] Correspondingly, access

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[52] Jonathan R. Macey, "Too Many Notes and Not Enough Votes: Lucian Bebchuk and Emperor Joseph II Kvetch About Contested Director Elections and Mozart's *Seraglio*", (2007) 93 Va. L. Rev. 759, 767.

[53] For an analysis of the relevant dynamics, see Lucian Bebchuk and Oliver Hart, "Takeover Bids vs. Proxy Fights in Contests for Corporate Control", (2001) N.B.E.R. Working Paper 8633.

[54] Patrick A. Gaughan, *Mergers, Acquisitions, and Corporate Restructurings*, 3rd ed. (New York: John Wiley, 2002), 277; Lucian Bebchuk, "The Myth of the Shareholder Franchise", (2007) 93 Va. L. Rev. 675, 688-89.

[55] Annys Shin, "Six Flags to Reimburse Snyder For Most Expenses in Proxy Fight", Washington Post, April 12, 2006, D4.

[56] Six Flags reimbursed most of Red Zone's expenses as Snyder succeeded in gaining full control of the board: *ibid.* On the general pattern, see Gaughan, *supra* note 54, 277; Bebchuk, *supra* note 54, 696-98.

[57] Offensive shareholder activism by wealthy individuals is by no means unknown, however. Klein and Zur

to sizeable amounts of capital is typically a pre-requisite for serious practitioners of this corporate governance tactic. As a venerable corporate "gadfly" said in a 2006 interview explaining how hedge funds had developed more clout than he and other similar activism veterans, "I don't have the money hedge funds have."[58]

Additional financing costs come into play as well. For instance, an activist shareholder, by owning sizeable stakes in target companies necessarily foregoes the benefits of risk-spreading available to passive, diversified investors.[59] In addition, there is a sacrifice in terms of liquidity, due to the fact that the sale of a sizeable block of shares in a public company is often difficult to execute without depressing the price.[60]

While rich individuals minded to engage in offensive shareholder activism may have the wherewithal to engage in offensive shareholder activism despite financing costs, others will need to be more creative. Theoretically, an individual investor could borrow to pay for the shares, but lenders are highly unlikely to make funds available unless the investor is well-off already. Another option for an activist will be to operate through the medium of a public company, meaning the acquisition of stakes in target firms can potentially be underwritten by retained earnings, the issuance of shares or corporate borrowing. This, of course, begs an obvious question: How does the activist achieve a sufficiently dominant role in a public company to begin launching offensive shareholder activism campaigns?

Offensive shareholder activism can also be financed by raising capital from investors willing to back an investment fund with a suitable mandate. Activist hedge funds in effect rely on this approach but financing costs come into play even for them. The conventional wisdom is that hedge fund activists focus primarily on the "small cap" sector.[61] Data compiled by Brav *et al.* for their study on hedge fund activism confirms the point.[62] They found that activism was less prevalent among companies within the top size quintile as compared with smaller firms and explained this in terms of the financial position of shareholder activists. The median size of the activist funds in their sample was $793 million and a 5% stake in the average top quintile target firm implied an investment of $760 million. As Brav *et al.* observed, "Acquiring a sizeable stake in a top size-quintile firm might introduce an inordinate amount of idiosyncratic portfolio risk even for an activist hedge fund."[63]

3. Benefits of Activism Accruing to the Insurgent Shareholder

The benefits of activism to a target company's shareholders as a whole (b_i) will comprise any increase in shareholder return generated by the activist's intervention. The percentage of shares owned will set an upper bound for the proportion of these benefits the activist shareholder will derive (i.e. $\alpha\ b_i$). However, because investors typically anticipate a shareholder activist's efforts once the activist's stake becomes public knowledge and drive the share price upward,[64] an additional constraint is imposed on the proportion of the benefits an activist will secure. Because the activist's post-disclosure gains must in effect be shared with the market, the proportion of the total benefits generated

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report that of 235 activist investors in their sample of "entrepreneurial activism" events occurring between 2003 and 2005, 38 were investment advisors to wealthy investors (*supra* note 2, at 14).

[58] Susan Chandler, "Hedge Funds Put the Pressure On", Chicago Tribune, January 27, 2006, C1 (quoting Martin Glotzer, who is the self-proclaimed "No. 1 shareholder activist and annual-meeting goer in the United States": Sophia Banay, "Idiosyncatic Investors", Conde Nest Portfolio, May 1, 2007, available at http://www.portfolio.com/executives/features/2007/05/01/Idiosyncratic-Investors).

[59] Steven Huddart, "The Effect of a Large Shareholder on Corporate Value", (1993) 39 Management Science 1407, 1407, 1413, 1415; Ian Ayres and Peter Cramton, "Relational Investing and Agency Theory", 15 Cardozo L. Rev. 1033, 1051 (1994).

[60] Macey, *supra* note 1, 256; see also John C. Coffee, "Liquidity Versus Control: The Institutional Investor as Corporate Monitor", (1991) 91 Columbia L. Rev. 1277, 1288-89, 1329-30.

[61] Bratton, *supra* note 2, 1387.

[62] Brav *et al., supra* note 2, 1752. Klein and Zur's findings are similar (*supra* note 2, 23).

[63] Brav *et al., supra* note 2, 1752.

[64] On the typical market reaction to a public announcement of a sizeable minority stake, see Ernst Maug, "Large Shareholders as Monitors: Is There a Trade-Off Between Liquidity and Control?", (1998) 53 J. Fin. 65, 67.

by improved shareholder returns which the activist will capture will typically be measured by reference to when the market first becomes aware of the activist's involvement rather than at the time of the activism. Put more formally, if we take λ (where $0 < \lambda < 1$) to be the maximum block of shares which can be purchased by "stealth", inequality (1) can be modified to state the conditions for activism as follows:

$$c_i < (\text{argmin } \{\alpha, \lambda\})\, b_i \qquad (2)$$

The size of λ will depend in large part on regulatory requirements for disclosure of block purchases. For instance, in the U.S., schedule 13D of the Securities Exchange Act of 1934, which requires the filing of an ownership report within 10 days after the acquisition of 5% or more of a company's shares, is an important factor.[65] 13D filings by hedge fund activists are associated with significant price effects,[66] implying that in the U.S. compulsory disclosure effectively sets the level of λ to 5% of the voting shares. Institutional money managers, including hedge funds, who manage assets of $100 million or more, also must disclose their holdings at the end of each quarter by filing a Form 13F with the S.E.C.[67] The filings are publicly available, but because reporting is quarterly and disclosure is not required until 45 days after each quarter,[68] activist shareholders not caught by schedule 13D have latitude to build up a sizeable stake in a target company before divulging what they have been doing.

4. Private Benefits

In some circumstances an activist shareholder may be able to secure private benefits from their interventions, which we might represent by introducing an additional term p_i into inequality (1):

$$c_i < (\alpha\, b_i + p_i) \qquad (3)$$

Private benefits will be particularly attractive for the activist because, by definition, these do not need to be shared with other target shareholders.[69] A variety of techniques might be employed to extract private benefits in the activism context. For example, using influence to prompt a target company to enter into major transactions with another entity controlled by the activist on terms favourable to the latter could generate significant p_i. Another technique, made infamous in the 1980s, is "greenmail", which occurs where the target company makes a focused repurchase of the insurgent's shares at a substantial premium to the market price in order to get them go away.[70]

Activism that *decreases* shareholder returns overall (that is, b_i becomes negative) can theoretically occur when an insurgent shareholder anticipates capturing sizeable p_i and will only bear a small proportion of any reduction in shareholder value due to owning a minority stake. Instances of hedge fund activism could plausibly fall into this category. There has been much discussion of the possibility of hedge funds benefiting at the expense of other shareholders in a target company through inverting their economic exposure to the target with derivatives and then using the shares they own to

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[65] The statutory foundation for schedule 13D is section 13(d) of the Securities Exchange Act of 1934: 15 U.S.C. § 78m(d).

[66] Klein and Zur, *supra* note 2, 25-27 (discussing their own results and summarizing other studies).

[67] 15 U.S.C. §78m (f)(1), (f)(5)(A); Exchange Act Rule 13(f)-1; 17 C.F.R. §240.13f-1.

[68] Henry C. Hu and Bernard S. Black, "The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership", (2006) 79 Southern Calif. L. Rev. 811, 871.

[69] Edward B. Rock, "Controlling the Dark Side of Relational Investing", (1994) 15 Cardozo L. Rev. 987, 1002-3 (making the same point about "relational" investors who acquire a sizeable stake in a company and reputedly seek to improve performance through monitoring).

[70] Jonathan R. Macey and Fred S. McChesney, "A Theoretical Analysis of Corporate Greenmail", (1985) 95 Yale L.J. 13, 14, 43-50 (discussing empirical studies of greenmail but arguing against the proposition that the practice was "unfair" to shareholders in the companies involved).

engage in opportunistic "empty voting".[71] For example, an activist shareholder could use equity swaps to take a net short position in the target company while using its status as a shareholder to push for corporate actions tending to lower the share price. However, the available evidence suggests that hedge fund activism on the whole has a positive impact on overall stock price performance, implying that this sort of self-serving strategy is not the principal motivation for the insurgencies hedge funds undertake.[72]

B. The Market for Corporate Influence – Supply Side

The costs and benefits associated with offensive shareholder activism will be affected by a range of variables operating at the firm level.[73] However, for our purposes—seeking to explain changes over time and predict future trends—systemic factors are of greater interest. In the remainder of this Part of the paper we identify and discuss these. To do so, we rely on the market for corporate influence heuristic, characterizing matters in terms of the supply side and demand side. Essentially, the opportunities for the profitable exercise of influence determine the "supply side" of this market while the "demand side" of the market defines the willingness of investors to pursue such opportunities. We start by considering the supply side.

The private benefit scenario aside, a necessary pre-condition for offensive shareholder activism is that there must be instances where $b_i > 0$. Companies falling into this category are likely to share three characteristics. First, the companies will be "undervalued", at least from the perspective of a likely activist. Second, the companies will have diffuse share ownership. Third, rights bestowed on shareholders by corporate law will provide the activist with sufficient leverage to capture management's attention.

1. Potential Targets

If a corporation is maximizing shareholder value and its performance is fully reflected in the share price, no investor will conclude $b_i > 0$ and, absent private benefits of control, offensive shareholder activism should not occur. On the other hand, once an investor – whether a hedge fund, Berkshire Hathaway (a.k.a. Warren Buffett) or a private individual – becomes convinced a company's shares are "underpriced", in the sense that the share price does not accurately reflect the underlying fundamentals, they may well calculate it is worth buying up a stake so as to profit when the market "catches up". With hedge funds minded to adopt an offensive shareholder activism strategy, as Part I.A discussed, there is a pivotal additional calculation involved. They typically will be looking for are companies that are not merely "underpriced" but also are "underperforming", in the sense that they anticipate a change in financial policy or strategic direction will increase shareholder returns (i.e. $b_i > 0$.) Offensive activists therefore seek out firms where shareholder returns can be improved significantly through a feasible intervention.

"Underperforming" in this context does not necessarily mean unprofitable. A company's earnings could be robust and yet, due to management failing to exploit financial or strategic opportunities available to unlock shareholder value, the company may not be maximizing returns to shareholders. Under such circumstances, there will be potential for an activist-minded investor to profit by buying up a sizeable stake and then intervening to lobby for changes predicted to correct matters.

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[71] Hu and Black, *supra* note 68, 817, 821, 845-46 (2006); Iman Anabtawi and Lynn Stout, "Fiduciary Duties for Activist Shareholders", (2008) 60 Stanford L. Rev. 1255, 1286-88.

[72] Thomas W. Briggs, "Corporate Governance and the New Hedge Fund Activism", (2007) 32 J. Corp. L. 681, 701-2.

[73] For a model of the variables likely to influence the probability that an investor lacking any form of initial endowment in a company will build up a stake and monitor, see Thomas H. Noe, "Investor Activism and Financial Market Structure", (2002) 15 Rev. Fin. Studies 289, 307-8.

2. Ownership Structure

There will in all likelihood be at any one time numerous companies trading on the stock market that could qualify as underperforming. Instances of $b_i > 0$ constitute only a subset of this cohort. This is because the extent to which an underperforming company represents an opportunity to generate benefits from activism depends on the feasibility of bringing about change. The ownership structure of the companies involved is an important limiting factor, in that dispersed stock ownership would seem to be a necessary precondition for an influence-based intervention to be worth attempting. This is because if a company has a shareholder who controls a sufficiently large block of votes to veto unwelcome shareholder resolutions, a shareholder activist is unlikely to be able to make credible proposals for change. Correspondingly, there will be no benefit to be gained in buying a stake that carries voting rights less than control (i.e. $b_i = 0$).

While influence-driven activism is unlikely to be deployed where dispersed ownership is lacking, there can be exceptions. One possibility is that an activist investor will buy up enough shares to take advantage of rights available to minority shareholders (e.g. the right to select a director in a company that provides for "cumulative" voting for directors) to put pressure on a company's dominant shareholder and its directors.[74] Another is where the dominant shareholder's leverage is dependent upon ownership of shares vested with outsized voting rights and the activist, anticipating ending up a key player, lobbies for the company to "normalize" the share structure by buying out the special class of shares. Barington Capital Group and Clinton Group adopted this tactic in 2008 with retailer Dillard's, where the founding family retained voting control by holding shares with multiple voting rights, but were rebuffed and had to settle for minority board representation.[75] Still, while there might be particular instances where offensive shareholder activism occurs in companies with a dominant shareholder, companies with dispersed share ownership are much more promising targets.

3. Shareholder Rights

The feasibility of bringing about change in an underperforming company will also partly be a function of "shareholder rights", meaning in this context legal rules governing the scope shareholders have to determine the composition of the board, to exercise a veto over board initiatives, to counteract the advantages management has in securing shareholder support through the solicitation of proxies and to bring a suit challenging alleged managerial wrongdoing. Enhancements in shareholder rights should encourage offensive shareholder activism, as credible challenges can be launched against a wider range of underperforming companies. A 2009 change to S.E.C. rules governing proxy voting by stockbrokers illustrates the point.

With proxy solicitations in U.S. public companies, a "ballot", in the form of a proxy card, is delivered to each shareholder and a shareholder can vote by returning the proxy in the manner specified. For the large proportion of shares held in nominee ("street") names, the right to vote has traditionally been exercised by the nominee brokers rather than the true owner.[76] This is because a New York Stock Exchange listing rule, applicable to all NYSE member organizations including NASDAQ, has allowed brokers to vote clients' shares on routine matters.[77] Since brokers almost

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[74] Matteo Erede, "Governing Corporations with Concentrated Ownership Structure: Can Hedge Funds Activism Play Any Role in Italy?" (2008), unpublished working paper, 19-21, 29, 31-32 (seeking to explain his finding that in Italy investment funds were just as likely to accumulate stakes of 2% or more in companies with a controlling shareholder as in companies with dispersed share ownership. A plausible alternative explanation for the empirical finding is that the investment funds buying shares in companies with dominant shareholders were merely value investors and had no intention of agitating for change, a possibility the author acknowledges -- see at 32-33).

[75] "Dillard's Side-Steps Proxy Fight", Knoxville News-Sentinel, April 3, 2008, 23 (board representation); Rachel Dodes, "Hedge Funds Seek Ousters at Dillard's", Wall Street J., October 28, 2008, B4 (unsuccessful lobbying for a buy out of the special class of shares held by the Dillard family).

[76] Anabtawi and Stout, *supra* note 71, 1282.

[77] NYSE Listed Company Manual, Rule 452 ("Giving Proxies by Member Organizations"). On the rule and its

always vote in the manner management suggests, when the rule applies the incumbent directors can typically count on support from a reliable block of "broker votes".[78] In 2009, the Securities and Exchange Commission voted to amend the New York Stock Exchange listing rules to categorize uncontested director elections as non-routine matters, thereby prohibiting brokers from exercising their discretionary voting power where a beneficial holder does not provide the broker with voting instructions.[79] Given that 19% of the votes cast during the 2009 proxy season were broker votes, this is a significant change, and its implementation generated predictions of fresh empowerment of activist shareholders and more frequent board changes.[80]

C. Demand Side

To ascertain the extent to which conditions are propitious for offensive shareholder activism it is necessary to consider not only the opportunities for the profitable exercise of influence but also the factors that may affect investors' ability and willingness to exploit such opportunities. These factors shape the demand function in the market for corporate influence.

1. Financing Costs

Even taking for granted that there are companies where $b_i > 0$, offensive shareholder activism will not occur if the costs associated with intervention (c_i) exceed the benefits available to the potential activist, factoring in the activist's partial ownership stake (α). As section A.1 of this part of the paper described, financing costs are one element of c_i, so, all else being equal, factors that drive these down should encourage shareholder activism and factors that increase them should do the opposite. The cost of borrowing is a straightforward example. If debt is "cheap" in the sense "risky" borrowing is inexpensive relative to "safe" borrowing, using leverage to accumulate sizeable stakes in target companies will become easier, which in turn should foster shareholder activism. Conversely, "expensive" debt will likely put a damper on the market for corporate influence.

The technological sophistication of markets can also have an impact on financing costs. As section A.2 of this part of the paper described, the fact activist shareholders invest large proportions of available capital in a small number of target companies means diversification is lacking and the riskiness of the share portfolio contributes to financing costs. Activist investors can adopt compensatory strategies, such as carrying out short sales of fully (or over-) priced securities otherwise similar to the shares of target companies.[81] Technological improvements which facilitate such hedging may be expected to lower the costs to activism.

Regulation can also influence financing costs. Investors contemplating engaging in offensive shareholder activism can potentially ameliorate financial constraints they face by acting in tandem with like-minded counterparts. For instance, the leverage insurgent hedge funds have quite often is bolstered by investors with a similar agenda, resulting in what have been pejoratively labelled "wolf

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history, see "Report and Recommendations of the Proxy Working Group to the New York Stock Exchange", June 5, 2006 (available at http://www.nyse.com/pdfs/REVISED_NYSE_Report_6_5_06.pdf , accessed July 3, 2009), 7-8.

[78] Anabtawi and Stout, *supra* note 71, 1282.

[79] Nixon Peabody, "SEC Approves Rule to Eliminate Broker Discretionary Voting for Director Elections", Securities Law Alert, July 2, 2009 (available at http://www.nixonpeabody.com/publications_detail3.asp?ID=2805; accessed July 3, 2009).

[80] David A. Katz and Laura A. McIntosh, "Populists' Wish List Offers Legislative Parade of Horribles", N.Y.L.J., July 23, 2009, 5.

[81] Seth A. Klarman, "The Timeless Wisdom of Graham and Dodd" in Benjamin Graham and David L. Dodd, *Security Analysis*, 6th ed., (New York: McGraw Hill, 2008), i, xxix. See also Bratton, *supra* note 2, 1383, n. 40 (indicating that at least some of the "value-directed" hedge funds from which activist funds tend to come adopt hedging strategies); "Strategy Focus: Time Ripe for Activists", Infovest21 Strategy Focus, August 5, 2006 (quoting Robert Chapman of Chapman Capital, saying his fund did "some intra-industry hedging").

packs".[82] Shareholder activists minded to work in tandem need to be mindful of relevant regulations. In the U.S., schedule 13D of the Securities Exchange Act of 1934, which again requires the filing of an ownership report within 10 days after the acquisition of 5% or more of a company's shares, is an important potential constraint.[83] Any two or more persons will be considered one aggregated filing group if they have agreed to act together for the purpose of acquiring, holding or voting shares. Agreement in this context may be informal and can be inferred from circumstantial evidence, so hedge funds constituting a "wolf pack" typically are very careful to ensure that their activities cannot be construed as establishing a Schedule 13D group.[84] A common strategy members of a putative "pack" adopt is to refrain from buying shares until after the hedge fund initiating matters has announced its stake.

2. Transaction Costs

In the offensive shareholder activism context transaction costs include -- the amount paid for the shares aside -- outlays associated with building up an influential stake in a public company. Search costs constitute one example, due to the fact a would-be activist will have to identify and investigate potential targets before proceeding. Over time, regulatory and technological changes may be expected to affect search costs. With respect to regulation, rules requiring corporations to disseminate publicly verified financial information should reduce search costs, because compulsory disclosure will mean that potential activists will have timely, credible data they can use to identify and evaluate potential targets. As for technology, it is currently possible for anyone with a computer terminal and a subscription to mainstream data providers to gain instant access to detailed financial data and substantial background information on thousands of publicly traded companies. The numbers can then be analyzed immediately through the use of sophisticated computer programs.

This, however, is a relatively recent state of affairs. As Richard Ennis, an investment consultant, observed in 2005, "In the past 30 years, we have experienced what may be the greatest period of innovation in information technology in the history of humankind."[85] Going back through time, the search costs involved with finding suitable targets would have been considerably greater than they are now, thus increasing c_i and, all else being equal, diminishing the scope for profitable shareholder activism. Ennis provides a flavour of how things have changed, saying that before the arrival of the personal computer in the mid-1970s "analysts relied on hand-held calculators, and those of us analyzing balance sheets in the 1960s used a slide rule for compound interest and present value calculations."[86]

Besides governing the ease with which suitable targets for activism can be found, technology can affect transaction costs associated with the buying and selling of shares, including stockbroking commissions and the spread between the bid and the ask price. In the U.S. the Buttonwood Tree Agreement of 1792 that fixed minimum stockbroking commissions was in effect until de-regulation in the 1970s.[87] In 1971 the Securities and Exchange Commission determined that commissions in excess of $500,000 were to be fully negotiable and in 1975 fixed commission rates were eliminated completely.[88] This de-regulation, combined with technological advances that made the mechanics of share dealing more efficient, caused trading costs as a percentage of trade value to fall in 1988 to roughly one-third what they had been in the 1970s and to 10% of 1970s levels by 2005.[89] This trend,

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[82] Briggs, *supra* note 72, 697-99.
[83] *Ibid*., 688-89.
[84] Brav *et al., supra* note 2, 1757, n. 12; Briggs, *supra* note 72, 698.
[85] Richard M. Ennis, "Are Active Management Fees Too High?", Fin. Analysts J., Sept./Oct. 2005, 44, 44.
[86] *Ibid*., 44-45.
[87] B. Mark Smith, *Toward Rational Exuberance: The Evolution of the Modern Stock Market* (New York: Farrar, Straus & Giroux, 2001), 3, 232.
[88] Bhide, *supra* note 28, 40.
[89] *Ibid*.; Ennis, *supra* note 85, 45.

by driving down c_i, should have created greater opportunities for profitable shareholder activism.

The transaction costs associated with offensive shareholder activism encompass in addition the communication costs that have to be incurred to persuade neutral shareholders to support proposed changes concerning the targeted firm (see sub-section A.2 of this part). Before the advent of the internet activists had to mail letters to shareholders or pay for ads in publications such as the *Wall Street Journal* to make their points.[90] Activists can now use e-mail, websites and private electronic chat rooms to communicate instantly and cheaply with potential allies and supporters. The falling cost of transmitting information to and between shareholders has in turn made it easier for dissidents to launch and fight public campaigns against incumbent managers.[91]

Regulation, as with technology, potentially has an impact on communication costs. In publicly traded companies, most votes are cast by proxy, so regulations affecting the proxy machinery are of particular importance in this context. With U.S. public companies, unless a regulatory "safe harbour" is available, any dissident shareholder minded to communicate with fellow investors to ask for proxies must incur expense preparing and filing documentation for review by the S.E.C. to ensure compliance with Rules 14a-1 through 14b-1 under the Securities and Exchange Act of 1934. These requirements increase c_i for shareholder activists. On the other hand, compliance with the S.E.C. proxy rules guarantees solicitation materials dissident shareholders prepare will be circulated to the shareholders and permits dissident shareholders in some circumstances to "piggyback" proposals at negligible cost on management's own proxy solicitation.[92] In addition, in the case of an activism campaign that involves a proxy battle, the information public companies are compelled to disclose under federal securities law generates credible financial data activists can draw upon readily to attempt to persuade neutral shareholders to vote against the incumbent management team.

3. Regulation of Collective Investment Vehicles

While those who believe they can generate superior risk-adjusted returns by engaging in shareholder activism will potentially have the financial resources required to proceed if they manage an investment fund that has sufficient capital, laws governing collective investment vehicles can be an obstacle. Lawmakers, to protect otherwise potentially vulnerable retail investors, might impose requirements on collective investment vehicles that circumscribe the investment strategies and compensation practices of approved funds. Regulations of this sort can deter shareholder activism by discouraging approved collective investment vehicles from adopting investment strategies required to make intervention viable (e.g. eschewing diversification to take large stakes in a small number of companies).

On this count, history is potentially instructive. The Investment Company Act of 1940 and the Investment Advisers Act of 1940, which introduced a package of safeguards to protect U.S. investors from misleading and dishonest practices allegedly engaged in by investment companies in the run up to the 1929 Wall Street crash, are often credited with discouraging regulated investment companies — now known as mutual funds— from engaging in activist investing.[93] Since shareholder activism is an expensive, time-consuming business, being proactive is unlikely to be worthwhile unless the targeted companies are a major component of a fund's investment portfolio and the fund manager is rewarded on the basis of positive "absolute" returns (i.e. returns calculated without regard for general market

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[90] "Winners and Losers", *supra* note 45.

[91] Gretchen Morgenson, "Shareholders are Restless, and Starting to Pounce", N.Y. Times, July 22, 2001, Business, 1; "Hail, Shareholder", Economist, June 2, 2007, 73.

[92] Reinier R. Kraakman *et al.*, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford: Oxford University Press, 2004), 42-43.

[93] 15 U.S.C. §§ 80a-1 to 80a-64 (Investment Company Act of 1940), §§ 80b-1 to 80b-21 (Investment Advisers Act of 1940). On the legislation's impact on shareholder activism, see Mark J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton, N.J.: Princeton University Press, 1994), 102-123; Ronald J. Gilson and Reinier Kraakman, "Investment Companies as Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate", (1993) 45 Stanford L. Rev. 985, 997-1003.

conditions or performance of peers).[94] U.S. mutual funds do not match the pattern congenial to activism. The vast majority are highly diversified and management fees, rather than being based on investor returns, take the form of a percentage of assets under management and a brokerage charge paid at the time of purchase ("front load").[95]

The 1940 legislation helps to account for mutual funds being ill-suited for offensive shareholder activism, both in terms of fee arrangements and diversification. By virtue of the legislation, a registered investment adviser is prohibited from receiving compensation "on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client" and mutual funds have little scope to base the management fee investors pay on the performance of the fund.[96] The requirement of a S.E.C. fairness review for self-dealing transactions further impedes the use of high-powered incentive compensation for mutual fund managers.[97]

The 1940 legislation also poses obstacles for money managers minded to take large positions in particular companies. Mutual funds prefer to designate themselves as "diversified", and the Investment Company Act of 1940 stipulates that they must satisfy stipulated criteria to do this.[98] Under the Act, 75% of assets under management by approved mutual funds are subject to rules prohibiting more than 5% of the assets being composed of the stock of any one portfolio company and precluding ownership of more than 10% of the voting securities of any company.[99] There are similar rules under tax law.[100] Mutual funds seeking to be treated as "regulated investment companies" so as to be eligible for "pass-through" tax treatment must have half of their assets diversified in the same way as the Investment Company Act of 1940 requires for 75% of the assets.[101] With the remaining half, no more than 25% of the total assets may be invested in any one company.[102]

While regulation may well deter mutual funds from engaging in offensive shareholder activism, in the U.S. it is not compulsory for collective investment vehicles to be organized in a manner that brings them within the scope of legislation imposing such restrictions. Instead, safe harbours can be relied upon by those minded to establish investment entities that ensure the 1940 legislation does not apply, as hedge funds illustrate. Hedge funds have traditionally side-stepped federal regulation affecting investment companies by raising capital privately from high net-worth individuals, pension funds, insurance companies, large charitable endowments and investment companies that invest in hedge funds (funds of hedge funds), thereby ensuring they are not subject to constraints applicable to an investment fund marketed widely to retail investors.[103] Aspects of the 1940 legislation that deter mutual funds from engaging in offensive shareholder activism correspondingly do not come into play, and it is from this cohort that hedge funds specializing in shareholder activism come.

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[94] Conference Board, *supra* note 41, 28-29, 31.

[95] Kahan and Rock, *supra* note 7, 1051; Robert C. Hillig, "What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight", (2007) 57 American Univ. L. Rev. 225, 311, 318.

[96] Hillig, *supra* note 95, at 318; 15 U.S.C. §80b-(5)(a)(1) (compensation); Kahan and Rock, *supra* note 7, 1050 (discussing 15 U.S.C. §80b-(5)(b)(2), indicating that pay-for-performance fees are impractical because performance fees must be based on a period of at least one year).

[97] 15 U.S.C. § 80a-17.

[98] Kahan and Rock, *supra* note 7, 1049.

[99] 15 U.S.C. § 80a-5.

[100] Hillig, *supra* note 95, 313.

[101] I.R.C. § 851(b)(3)(A).

[102] I.R.C. § 851(b)(3)(B).

[103] Kahan and Rock, *supra* note 7, 1062; Jonathan Bevilacqua, "Convergence and Divergence: Blurring the Lines Between Hedge Funds and Private Equity Funds", (2006) 54 Buffalo L. Rev. 251, 257, 267. On key exemptions relied upon, see *infra* notes 185 to 194 and accompanying text.

III. THE RISE OF SHAREHOLDER ACTIVISM BY HEDGE FUNDS

A. Offensive Shareholder Activism During the "Deal Decade"

Having canvassed generally the variables likely to dictate how the market for corporate influence will operate, we now turn specifically to hedge funds. To account for the emergence of hedge funds as key offensive shareholder activists, it is necessary to determine as a preliminary matter when they first moved to the forefront. This part of the paper provides the relevant chronology, tracing developments up to the financial crisis of 2007/08. We will see that shareholder activism was very much a minority pursuit in the hedge fund sector through to the end of the 1990s. Hedge funds only began carrying out offensive shareholder activism in earnest at the beginning of the 2000s and stepped up their efforts as the decade proceeded.

When hedge funds emerged as shareholder activists, they were hardly pioneers. Instead, more than a century ago there were investors prepared to build up stakes in public companies and engage in offensive shareholder activism. For instance, Allen Boyer argued in a 1993 article on activist shareholders that Jay Gould, a prominent "robber baron" during the second half of the 19th century, was "the consummate example of the active shareholder", looking constantly for "weak spots" in which to buy a sufficiently large minority stake to obtain leverage to orchestrate changes designed to result in a rise in the share price then exit at a profit.[104] There were instances of offensive shareholder activism in the U.S. at various junctures throughout the 20th century and "proxyteers" such as Louis Wolfson and Robert Young achieved considerable notoriety in the 1950s after launching proxy battles contesting board control in major U.S. public companies.[105] However, to find the direct antecedents to hedge funds as practitioners of offensive shareholder activism, the appropriate place to turn is the 1980s.

The 1980s was known as "the Deal Decade", exemplified by corporate "raiders" relying on aggressive, innovative financial techniques to engineer daring takeover bids.[106] While the 1980s raiders achieved notoriety for their activities in the market for corporate control, many also bought and held significant stakes in companies in the manner associated with offensive shareholder activism. Bethel, Liebeskind and Opler report that among a sample of 425 firms in the Fortune 500 as of 1980 there were throughout the course of the decade 244 block purchases (i.e. the acquisition of a stake of 5% of the shares, thus requiring disclosure to the S.E.C.), an average of 0.57 per firm.[107] According to Bethel *et al.* 151 of these 244 block purchases were by "activist" investors, meaning the investor taking up the stake was not a "financial" blockholder (a pension fund, mutual fund, bank, *etc.* which did not publicly adopt an activist position) or a "strategic" investor (a non-financial investor unopposed by management). The activist cohort, moreover, acted in ways consistent with the pattern ascribed to hedge funds in the 2000s, in that they targeted underperforming firms, and did so with a view to improving matters by prompting change.[108] With the target companies in Bethel *et al.*'s sample CEO turnover, share repurchases and divesture rates markedly exceeded the pre-intervention

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[104] Allen D. Boyer, "Activist Shareholders, Corporate Directors, and Institutional Investment: Some Lessons from the Robber Barons", (1993) 50 Wash. & Lee L. Rev.977, 1009; see also Julius Grodinsky, *Jay Gould: His Business Career 1867-1892* (Philadelphia: University of Pennsylvania Press, 1957), 22-23.

[105] On major proxy battles of the 1950s, including those involving Young and Wolfson, see David Karr, *Fight for Control* (New York: Ballantine Books, 1956). We are currently researching instances of offensive shareholder activism occurring during the first half of the 20th century – see *infra* Part IV.A.

[106] Mary O'Sullivan, *Contests for Corporate Control: Corporate Governance and Economic Performance in the United States and Germany* (Oxford: Oxford University Press, 2000), 161.

[107] Jennifer E. Bethel, Julia Porter Liebeskind and Tim Opler, "Block Purchases and Corporate Performance", 53 J. Fin. 605 (1998).

[108] *Ibid.*, 619 (indicating targets typically suffered from low profitability). Activist hedge funds have not necessarily targeted companies with low profitability, but there is a tendency to focus on companies with poor stock performance: *supra* note 21 and related discussion.

norm.[109]

Who were these predecessors to hedge fund shareholder activists? Bethel *et al.* say little about the identity of those in their activist group, but indicate the cohort included a number of well-known raiders such as Carl Icahn as well as other well-known investors such as the Bass Brothers, members of a wealthy Texas family that achieved notoriety in investing circles for securing in 1984 a lucrative targeted share repurchase of a 10% stake in Texaco and for acting the same year as a successful "white knight" for Walt Disney Productions when it faced an unwelcome tender offer.[110] Otherwise, prominent practitioners of offensive shareholder activism typically operated through the medium of a publicly traded firm.

Charles Bludhorn, chairman of the conglomerate Gulf & Western, was one example. Bludhorn hunted for undervalued companies that his company could buy a minority stake in and, as of 1981, Gulf & Western owned 20% or more of the voting shares in five companies and at least 5% in nearly a dozen more.[111] Victor Posner, a corporate raider who similarly accumulated sizeable minority stakes in a wide range of public companies (28 as of 1980), used as his chief investment vehicles NVF Co., a public company in which Posner held a stake of around 40%, and Sharon Steel Ltd., another public company in which NVF Co. held a majority stake.[112] Irwin Jacobs, who during the 1980s bought up sizeable stakes in numerous public companies but only rarely followed through on promises to bid for full control, started out doing deals personally or with a small group of private investors but then used Minstar, a public company in which he held a 37% stake, as the vehicle for his transactions.[113] T. Boone Pickens, another well-known corporate raider who took up sizeable stakes in a variety of target companies (typically in the oil industry) but customarily "struck out" in his attempts to secure full voting control, used Mesa Petroleum Co., a public company he founded in the 1960s, to carry out his best-known forays.[114]

The Investment Company Act of 1940 likely influenced the decision by activists to operate through the medium of a publicly traded company rather than an investment fund. As Part II.C.3 discussed, the Act restricts in various ways the ability of regulated mutual funds to engage in activism. However, publicly traded holding companies having a business of their own and having no more than 40% of total assets invested in stocks of other companies are outside the scope of the Act.[115] Even if investments in other companies' stocks exceed 40% of a holding company's asset value, it will still not be deemed to be an investment company if, either directly or through its subsidiaries, it is primarily engaged in a business other than investing, owing or trading in securities.[116]

Though most of the 1980s raiders used public companies as vehicles for their activism, Carl Icahn was something of an exception. Described by the *New York Times* in 2007 as "a lone wolf",[117] he acted on his own (or more precisely his New York brokerage firm acted on its own) with his first foray into activism, the acquisition in 1977-78 of a nearly 10% stake in Tappan Co., a household

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[109] Bethel, Liebesking and Opler, *supra* note 107, 624.

[110] Peter Elkind, "The Breakup of the Bass Brothers", N.Y. Times, November 24, 1991, Sunday Magazine, 34.

[111] George Anders, "G&W's Bludhorn, a Weekend Picker of Stocks, Chronicles His Search for Undervalued Issues", Wall Street J., November 20, 1981, 55; Clifford G. Holderness and Dennis P. Sheehan, "Raiders or Saviors? The Evidence on Six Controversial Investors", (1985) 14 J. Fin. Econ. 555, 556, 578.

[112] Debra Whitfield, "Posner: Many Corporations Fear His Swift Strike", Los Angeles Times, July 20, 1980, F1; Mark Potts, "Corporate Shark Swims Into Trouble", Washington Post, March 31, 1985, 113.

[113] "Jacobs Set to Stalk Corporate Prey", Chicago Tribune, March 31, 1985, S7B; Richard Gibson, "Irwin Jacobs Seeks to Attract $2.5 Billion from Backers to Finance Takeover Quest", Wall Street J., July 29, 1985, 2; Winston Williams, "A Raider Takes Command at AMF", N.Y. Times, Sept. 1, 1985, F1. Jacobs took Minstar private in 1988: "Bank Financing is Arranged for Proposal to Go Private", Wall Street J., May 27, 1988, 28.

[114] Mark Potts, "Pickens' Raids", Washington Post, October 30, 1983, G1; John N. Ingham and Lynne B. Feldman, *Contemporary American Business Leaders: A Biographical Dictionary* (New York: Greenwood Press, 1990), 524-28. In 1985, Mesa transformed itself into a publicly traded limited partnership: Debra Whitfield, "Mesa Plans to Change Into Partnership", L.A. Times, August 27, 1985, C1.

[115] 15 U.S.C. § 80a-3(a)(1)(C).

[116] 15 U.S.C. § 80a-3(b).

[117] Joe Nocera, "From Raider to Activist, But Still Icahn", N.Y. Times, February 3, 2007.

appliance manufacturer.[118] By the mid-1980s, Icahn's stock purchases were being "made through a maze of corporations and partnerships", ultimately backed by Icahn and 40 or so "silent partners".[119] Still, the lone wolf label held true to a significant extent, as Icahn's take amounted to approximately 80% of net profits.[120] Only in the 2000s did he secure sizeable outside investment, as he launched in 2004 a hedge fund, Icahn Partners, which raised $1.6 billion.[121]

While during the 1980s it was standard for offensive shareholder activism to be carried out through the medium of a publicly traded company, a tiny handful of activists began operating through the medium of private investment funds. These practitioners of offensive shareholder activism can be considered the direct antecedents to activist hedge funds and in at least a couple of instances the history of high-profile activists of the 2000s can be traced back to the end of the Deal Decade. Steel Partners, founded by Warren Lichtenstein in 1990 at the age of 24, is one example.

Steel Partners was established to buy 9% of Kinark, a small Oklahoma steel galvanizing outfit that Lichtenstein and his partners felt was undervalued.[122] Steel Partners' bid was rebuffed, but it continued on the same track soon thereafter when in it sought to parlay a stake of less than 5% in Park-Ohio Industries Inc., a diversified industrial manufacturer, into board representation.[123] In 1993 Lichtenstein launched Steel Partners II as a hedge fund with a mandate to invest in underperforming firms and, if necessary, to seek to fix companies to increase shareholder value.[124] Steel Partners II was a prominent hedge fund activist during the 2000s.[125] However, through the 1990s it operated on a modest basis, with one of the firm's partners saying in 1999 that it had only six employees and holdings of closer to the tens of millions of dollars rather than hundreds.[126]

Edward Lampert's ESL Investments, which generated headlines in the 2000s with investments in retailers Kmart and Sears,[127] is another high-profile activist hedge fund with a history extending back to the end of the Deal Decade. In 1988 Lampert, then aged 26, launched ESL as a private partnership and quickly parlayed a reputation for identifying undervalued stocks into investments from various wealthy backers.[128] After ESL suffered heavy losses in the bear market of 1990-91, Lambert, eager to ride out future market fluctuations undisrupted, asked his investors to lock their money into the partnership for five years and agreed in return not to take in any new partners until 1998.[129] Such restraint likely accounts for the fact that Lampert was, according to the *Wall Street Journal*, a "lesser-known" activist in 2001 despite delivering returns averaging 29% annually between 1988 and 2004.[130]

Other offensive shareholder activists operating through the medium of investment funds that achieved notoriety in the 1980s proved less resilient. In 1978, Natalie Koether, a lawyer, launched

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[118] "A Stalker of Takeover Gains", Business Week, June 11, 1979, 97; Richard Phalon, "The Return of the Proxy Fighter", Forbes, November 12, 1979, 37; Stanley Ginsberg, "Sitting Ducks", Forbes, April 14, 1980, 115. Icahn set up Icahn & Co. with his own funds and financial backing from his uncle: Ken Auletta, "The Raid: How Carl Icahn Came Up Short", New Yorker, March 20, 2006, 132. As of 1979 he "call(ed) most of the shots" with the company: James O'Shea, "Wall St. High Roller Trying a New Game", Wall Street J., May 27, 1979, F1.

[119] Stanley Penn, "Friends and Relatives Hitch Their Wagon to Carl Icahn's Star", Wall Street J., Oct. 2, 1985, 1.

[120] *Ibid.*

[121] Susan Pulliam and Martin Peers, "Once a Lone Wolf, Carl Icahn Goes Hedge-Fund Route", Wall Street J., August 12, 2005, A1.

[122] Taub, *supra* note 17.

[123] "Steel Partners Seek Answers from Park-Ohio", Plain-Dealer (Cleveland), March 24, 1992. On Park-Ohio Industries, see "Park-Ohio Industries", Encyclopedia of Cleveland History, available at http://ech.cwru.edu/ech-cgi/article.pl?id=PII (accessed July 8, 2009).

[124] Taub, *supra* note 17.

[125] *Ibid.*

[126] Ellen Simon, "Future Flickers for Lighter Company", The Star-Ledger (Newark, N.J.), March 18, 1999, 21.

[127] Berner, *supra* note 30 (Kmart); "Testing", *supra* note 30 (Sears).

[128] Joanne Lipman, "Driven to Succeed, Young Investor Makes the Right Connections", Wall Street J., June 27, 1991.

[129] Brett D. Fromson, "How to Make a Million", Washington Post, September 10, 1995, H01.

[130] Robin Sidel, "More Investors Turn Activist in Tough Times", Wall Street J., April 13, 2001, C1; Berner, *supra* note 30 (1988-2004 returns).

Shamrock Associates together with her husband to make sizeable investments in companies thought to be undervalued and cajole management – including via the threat of a takeover bid – to make changes. During the mid-1980s *Fortune* and *Business Week* both reported on Koether's efforts and funds under management grew from $1.2 million in 1979 to roughly $20 million in 1987.[131] Shamrock Associates targeted more than 40 companies, and in at least 12 instances management bought out its stake at a premium to make it go away.[132] However, as one of Shamrock's partners said subsequently, "Our time came. It was great while it lasted, then it was over."[133]

The pattern was similar with Coniston Partners, an investment partnership formed in 1982 by Keith Gollust, Paul E. Tierney and Augustus K. Oliver. The *Wall Street Journal* said of the business model: "Coniston typically would buy 10% to 20% of the stock of the target company, then use that block of stock as a club to press for drastic action – a breakup, asset sale, or even a takeover that would enable Coniston to sell out at a profit."[134] By 1987 Coniston Partners was on a *Fortune* list of the top 12 "raiders" and as of 1988 it had built up a war chest of approximately $700 million.[135] In 1990, however, Gollust, Tierney and Oliver shut down the investment pool and returned the capital to investors, citing the fact that Coniston's investment strategy was difficult to execute with the vibrant junk bond market of the 1980s having collapsed and banks having become reluctant to engage in risky lending. As Gollust explained at the time, "Any form of restructuring or sale of the business generally involves creating highly leveraged companies. Obviously, financing for highly leveraged companies is harder to sustain."[136]

B. Hedge Funds Move to Centre Stage

During the 1990s, hedge funds grew in prominence as an investment option but hedge fund managers showed little inclination to take up the activist mantle. Headlines from the *New York Times* reflect these trends, proclaiming in 1995 "Hedge Funds Still Steaming Ahead" and asking in 1996 "Where, Oh Where, Have All the Corporate Raiders Gone?"[137] It was only in the 2000s that hedge funds moved to centre stage as shareholder activists.

There have been since at least 1949 collective investment vehicles investing in equities that have operated outside the scope of the Investment Company Act of 1940 and adopted trading strategies designed to "hedge" risk.[138] However, hedge funds were typically an esoteric investment sideshow until the 1990s. As of 1990, there were approximately 300 hedge funds operating in the U.S. with approximately $40 billion under management, compared with mutual fund portfolios totalling $1.6 trillion.[139] The hedge fund industry then experienced what the chairman of the S.E.C. called in 2002 a "seismic boom".[140] By 1998, the number of hedge funds had grown to roughly 3,000, managing

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[131] Eleanor Johnson Tracy, "A New Greenmailer Swings Into Action", Fortune, August 5, 1985, 71; Peter Finch, "Natalie Koether: The Lady is a Raider", Business Week, February 23, 1987, 118.

[132] Finch, *supra* note 131; Paul Fiorilla and Mukul Pandya, "The Koethers Aim at a New Target", Business News New Jersey, July 10, 1996, 4.

[133] Ellen Simon, "Natalie Koether, 63, a Giver and a Taker", Star-Ledger, October 8, 2003, 51.

[134] Randall Smith, "Top Raider Coniston to Disband", Wall Street J., June 22, 1990, C1.

[135] Thomas Woods, "How the 12 Top Raiders Rate", Fortune, September 28, 1987, 44; Mariann Caprino, "Coniston Group: Persuaders, Not Raiders", Washington Post, August 21, 1988, H2.

[136] Smith, *supra* note 134. See also Martha M. Hamilton, "Coniston Partners Decide to Close Investment Pool", Washington Post, June 23, 1990, C1; Susan Antilla, "Coniston Turns New Leaf", USA Today, June 25, 1990, 28.

[137] Laurence Zuckerman, "Hedge Funds Still Steaming Ahead", N.Y. Times, January 25, 1995, D1; Margaret Isa, "Where, Oh Where, Have All the Corporate Raiders Gone?", N.Y. Times, June 30, 1996, F10.

[138] S.E.C. Staff Report, "Implications of the Growth of Hedge Funds" (2003), 3 (available at http://www.sec.gov/news/studies/hedgefunds0903.pdf); Frank S. Partnoy and Randall S. Thomas, "Gap Filling, Hedge Funds and Financial Innovation", (2006) Vanderbilt Univ. Law and Economics Working Paper No. 06-21, 23-24.

[139] S.E.C. Staff Report, *supra* note 138, 2; Erik J. Greupener, "Hedge Funds are Headed Down-market: A Call for Increased Regulation", (2003) 40 San Diego L. Rev. 1555, 1561.

[140] Quoted in Greupener, *supra* note 139, 1556.

around $300 billion in assets.[141]

During the 1990s, hedge funds that carried out "macro" bets on the direction of currencies and interest rates were the newsworthy players in the hedge fund industry.[142] Most hedge funds in fact did not pursue such trading strategies, and some specialized in "old-fashioned" value-oriented stock selection,[143] with perhaps the best known being Julian Robertson's Tiger Fund, a high profile "stock picker" that focused on situations where the underlying fundamentals implied shareholder returns would improve markedly over time.[144] However, these hedge funds rarely followed up by engaging in offensive shareholder activism.

During the mid-1990s Greenway Partners, a hedge fund run by Alfred Kingsley, did use shareholder proposals to agitate for change at a number of public companies (e.g. U.S. Shoe, Woolworth and Unisys Corp.).[145] However, when Robertson's Tiger Management made a filing with the S.E.C. in 1999 indicating that it was a 22% shareholder in U.S. Airways Group, this was characterized by the *Wall Street Journal* as "an unusual step for a money manager to take."[146] Similarly, in a 1998 *Wall Street Journal* article on activists taking aim at small cap companies with share prices languishing during the "dot.com" bull market, the only investment fund mentioned was La Salle Financial Partners, a Michigan based investment group with only $35 million worth of funds under management.[147]

The banking sector proved to be something of an exception. In 1996, *U.S. Banker* ran a cover story entitled "Banking's TOUGHEST Owners" that opened with a description of Stephen Gordon, the then 33-year old former investment banker running Genesis Financial Partners, who "loves to take big positions in community-based financial institutions with lackluster performance records. Then he starts throwing his weight around."[148] *U.S. Banker* said Gordon was "representative of a new breed of investors in banks and thrifts whose numbers and clout have grown explosively in the 1990s: financial institution hedge funds."

Having labelled hedge funds as "little-known investment operations", *U.S. Banker* brought its readers into the picture by explaining what hedge funds were, saying they had become defined as any private investment partnership designed to escape S.E.C. rules on mutual funds, regardless of whether they hedged their positions. Still, while hedge funds began throwing their weight around with banks in the 1990s, the best known instance of offensive shareholder activism in this sector – Michael Price building up a 6% stake in Chase Manhattan in 1996 and browbeating management until Chemical Bank bought Chase – was led by a mutual fund manager, not a hedge fund manager.[149] Hence, while hedge funds were becoming an important part of the investment scene in the 1990s, they remained an offensive shareholder activism side-show.

Matters changed in the 2000s. The managing director of Liberation Investment Group LLC, a Los Angeles hedge fund focusing solely on buying shares in underperforming companies and making changes at those firms, said in 2003 of the hedge fund sector "Very few managers make all their investments with the intent of going after management and the board."[150] However, a new approach was becoming evident.

In 2001, the *Wall Street Journal* drew attention to the fact "dissatisfied shareholders are

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[141] Partnoy and Thomas, *supra* note 138, 24.

[142] See, for example, Laura Jereski, "Hedge Fund Kings Profit Handsomely, Racking Up a 3-Year Winning Streak", Wall Street J., December 30, 1993, C1; Stephen Taub, "The Hedge Rows of Wall Street: It's Shakeout Time for the Former Hedge Fund Hotshots", Fin. World, September 13, 1994, 38.

[143] Gary Weiss, "Fall Guys?", Business Week, April 25, 1994, 116.

[144] Fredrick E. Rowe, "The Best Instincts in the Jungle", Forbes, September 16, 1991, 78.

[145] Robert A. Bennett and Neil Stewart, "Small Breed; The Greenway Way", Investor Relations, October 1996.

[146] Susan Pulliam and Mitchell Pacelle, "US Air Headache", Wall Street J., August 4, 1999, C1.

[147] Linda Sandler, "Share Activists Take Aim at Small Stocks", Wall Street J., August 4, 1998, C1.

[148] Sam Zuckerman, "Banking's TOUGHEST Owners", U.S. Banker, February 1996, 30.

[149] Andrew E. Serwer,"Mr. Price is on the Line", Fortune, December 9, 1996, 70.

[150] Ron Orol, "Governance Play", Daily Deal, September 15, 2003, quoting Manny Pearlman.

aggressively pushing companies to find new ways to unlock shareholder value" and said that "(a)mong the growing ranks of activists are…even hedge-fund managers, who historically have been relatively passive."[151] *Business Week* featured hedge funds Highfields Capital Management and Chapman Capital LLC in a 2002 article on "value investors" minded to challenge existing management for the sake of value creation, saying "Their style of investing is taking off like a Fourth of July bottle rocket."[152] *Institutional Investor* observed similarly in 2003 "No-nonsense, seize-the-board, put-the-company-in-play, do-whatever-it-takes-to-increase-the-stock-price corporate activism is coming back into style – and hedge funds are at the cutting-and-slashing edge."[153] By 2005, the *Wall Street Journal* was proclaiming "Hedge Funds are New Sheriffs of the Boardroom" and *Business Week* was referring to the "exploding number of activist hedge funds" and the "onslaught from hedge funds."[154] The founder of Chapman Capital LLC even complained in 2006 that what had been a niche area had become a crowded field with numerous hedge funds competing for activist opportunities using similar strategies.[155]

Data compiled by Georgeson Shareholder, a provider of shareholder consulting services, confirms the chronology concerning the emergence of hedge funds as shareholder activists. Georgeson identifies in annual reports on corporate governance available back to 1996 the dissidents responsible for proxy battles and other high-profile activist events affecting U.S. public companies, and the listings show hedge funds evolving from an activism side-show to centre stage operators.[156] For 1996, of 28 incidents listed by Georgeson, hedge funds were only responsible for five, two led by Gordon's Genesis Financial Partners, two by Greenway Partners and one by Steel Partners.[157] As of 1999, among 30 activist incidents, ten were initiated by nine different hedge funds.[158] For 2007, Georgeson listed 46 contested proxy solicitations, 20 of which were commenced by 16 different hedge funds.[159]

Other statistical measures capture the same hedge fund activism trend. According to Hedge Fund Research, hedge funds that used shareholder activism as part of their investment strategy managed almost $100 billion worth of assets as of 2006, compared with $23 billion in 2002.[160] Brav *et al.* used Schedule 13D filings to compile a database of activism "events" occurring between 2001 and 2006 and report that while 39 hedge funds were responsible for 97 events in 2001, by 2006 the figures were 126 and 252 respectively, with the numbers increasing almost monotonically throughout the period.[161]

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[151] Sidel, *supra* note 130.

[152] "The Ultimate Value Investors", Business Week, June 10, 2002, 124.

[153] "Proxy Warriors", Institutional Investor, January 2003.

[154] Alan Murray, "Hedge Funds are New Sheriffs of the Boardroom", Wall Street J., December 14, 2005, A2; "Take Your Best Shot, Punk", BusinessWeek, November 7, 2005, 118.

[155] Alistair Barr, "Activist Hedge-Fund Returns Wane as Their Niche Gets Crowded", MarketWatch, Sept. 14, 2006.

[156] The reports are available at http://www.georgesonshareholder.com/usa/resources_research.php (last visited October 24, 2008).

[157] Georgeson Shareholders, *Corporate Governance: Annual Meeting Season Wrap Up* (1996), 15.

[158] Georgeson Shareholders, *Corporate Governance: Annual Meeting Season Wrap Up* (1999), 15. The hedge fund dissidents were Deep Discount Advisers (two instances), Bay Harbor Management, Greenway Partners, JJF Group Inc., Mid-Atlantic Investors, Monterey Stockholders Group LLC, Palo Alto Investors, Sandera Partners LP and Steele Partners II LP (one instance each) (Steele presumably was a misspelling of the Steel Partners II).

[159] Georgeson Shareholders, Georgeson Shareholders, *Annual Corporate Governance Review 2007 Annual* (2008), 48-49. The hedge fund dissidents were Breeden Capital Management, Bulldog Investors (with Phillip Goldstein), Harbinger Capital Partners, Western Investment LLC (two instances each), Chapman Capital Corp., D.E. Shaw & Co., Everest Special Situations Fund LP, Flagg Street Capital LLC, Lawrence Garshofsky and Lawrence Partners LP, Metropolitan Capital Advisers Inc., Olive Press Partners LLC, Pembridge Capital Management LLC, Pershing Square LP, Ramius Capital Group LLC, Steel Partners II, Wynnefield Partners Small Cap Value LP (one instance). For 1999 and 2007, hedge funds were identified using Google and searches of the Lexis/Nexis newspaper database.

[160] Barr, *supra* note 155.

[161] Brav *et al.*, *supra* note 2, 1739.

IV. WHY DID HEDGE FUNDS COME TO DOMINATE THE MARKET FOR CORPORATE INFLUENCE?

A. Discounting Potentially Relevant Variables

Part II of this paper identified, deploying the market for corporate influence heuristic, variables likely to determine the prevalence of offensive shareholder activism. We anticipate that if the time horizon is extended far enough back each will be relevant to some degree. We are investigating this further in related research, using as our departure point proxy fights reported in the *ProQuest* historical newspaper database between 1900 and 1949. However, with respect to explaining the emergence of hedge fund activism in the 2000s, certain variables Part II analyzed can likely be discounted.

Legal reforms enhancing shareholder rights stand out as one example. As Part II.B.3 discussed, legal rules that provide shareholders with leverage *vis-à-vis* a company's management team can potentially encourage adoption of influence-based activism strategies because there should be a wider range of underperforming companies where a credible challenge can be made. In the U.S., however, the key reform initiative of this character that was under consideration as hedge fund activism surged was never implemented. In response to corporate governance scandals and pressure from investor groups, the Securities and Exchange Commission in 2003 proposed a "proxy access" rule that would have let shareholders with significant stakes nominate under limited circumstances a small minority of directors on a company's own proxy card.[162] The corporate community lobbied forcefully against the proposed rule and no action was taken.[163]

Search costs constitute another example. Given technological advances and the expansion of compulsory disclosure regulation, an investor today who is inclined to engage in offensive shareholder activism will find it much easier to find suitable targets than would have been the case for an investor in the 1930s or even the 1970s.[164] On the other hand, while I.T. capabilities have advanced considerably in many ways over the past decade or so, data providers were supplying detailed financial information on public companies instantaneously at a relatively modest cost throughout the 1990s, meaning that the rise of hedge-fund shareholder activism in the 2000s cannot be readily attributed to declining search costs.

The situation is much the same with transaction costs associated with the buying and selling of shares. The growth of algorithm-driven high-frequency trading has recently been pushing down bid-ask spreads.[165] Nevertheless, as Part II.C.2 described, the most dramatic technological and regulatory changes had occurred by the end of the 1990s. As a result, falling trading costs likely do not account for the recent prominence of hedge funds in the shareholder activism realm.

B. Supply Side

Applying the market for corporate influence heuristic, variables likely to influence the prevalence of offensive shareholder activism can be categorized on the basis of whether they impact upon the supply side or the demand side. Underperforming companies constitute one element of the supply side of the market for corporate influence that came into play with the rise of hedge fund activism at the beginning of the 2000s. A sizeable and sustained fall in share prices following the end of the dot.com stock market boom (Fig. 1) meant there was a sizeable cohort of companies trading at prices well below recent peaks and revelations of high-profile scandals at companies such as Enron, Tyco and WorldCom cast doubts on the quality of management in public companies. Correspondingly there should have been numerous companies where $b_i > 0$. Indeed, the *Wall Street Journal* said in 2001 that

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[162] Security Holder Director Nominations, Exchange Act Release No. 34-48626 (October 14, 2003), available at http://www.sec.gov/rules/proposed/34-48626.htm .

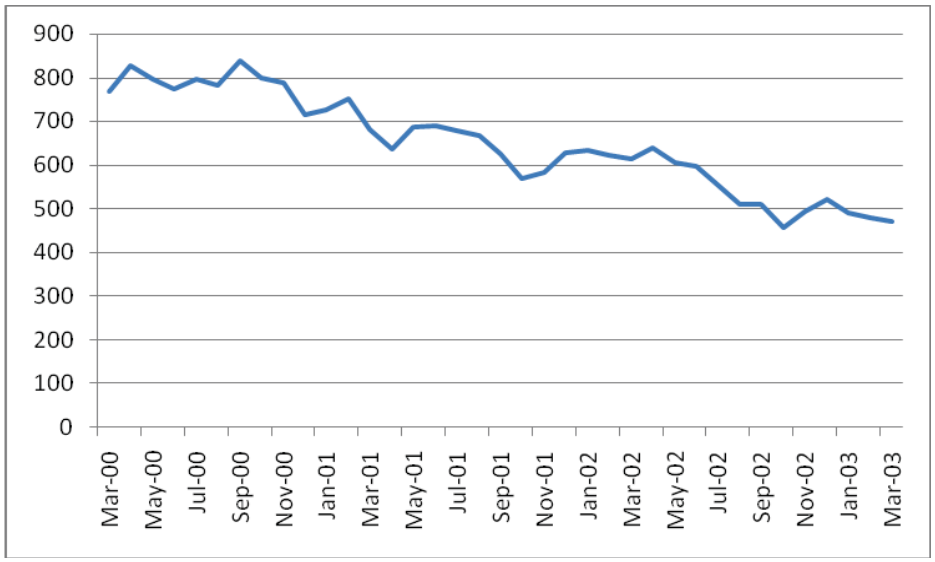
[163] Kathleen Pender, "Director Voting Under Fire", San Francisco Chronicle, March 20, 2005, B1.

[164] On the 1970s, see *supra* note 86 and related discussion.

[165] On high-frequency trading, see "Rise of the Machines", Economist, August 1, 2009, 64.

proxy experts were attributing a surge in shareholder activism during this era "to the sickly stock market, noting that the resurgence of conservative value investing has heightened shareholder attention on companies that were ignored in the technology boom."[166] Or as the *New Yorker* observed in 2003, "During the bull market, investors got lazy, leaving shareholder-rights advocacy to the gadflies and the geeks….The disasters at Enron and Tyco changed all that, and it has become fashionable again to question the judgment of the C.E.O…."[167]

FIGURE 1: RUSSELL 3000 INDEX, MARCH 2000 – MARCH 2003 (BASED ON PRICES AT THE BEGINNING OF EACH MONTH)



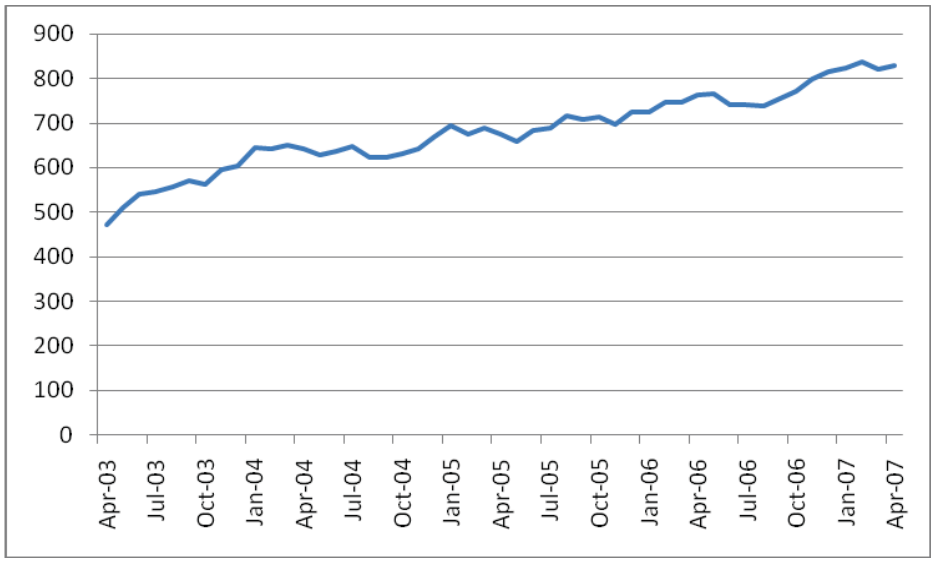
Source: Derived from figures available on Yahoo! Finance

Share prices rose smartly following the end of the bear market of the early 2000s, which seemingly implies there would have been few targets for activist hedge funds to aim at (Fig. 2). However, activist hedge funds still found numerous companies to pursue that were ostensibly underperforming. Most prominently, activist managers maintained public companies could readily unlock shareholder value by abandoning conservative financial policies. Following the bear market, corporate earnings grew smartly due to an expanding economy while executives, still shell-shocked by recessionary conditions, refrained from spending heavily on capital investment or increasing wages.[168] Correspondingly, by 2005, the corporations in the Standard & Poor's 500 stock index had accumulated between them $650 billion in cash, up from $329 billion in 2000, and cash accounts of the full range of nonfinancial firms had expanded at a similar rate.[169] Activist shareholders argued that companies should return funds earning paltry returns in the corporate treasury to shareholders by increasing dividend pay-outs, carrying out share buy-backs or even putting the company up for sale.[170]

FIGURE 2: RUSSELL 3000 INDEX, APRIL 2003 – APRIL 2007 (BASED ON PRICES AT THE BEGINNING OF

[166] Sidel, *supra* note 130.
[167] James Surowiecki, "To the Barricades", New Yorker, June 9, 2003, 44.
[168] Bratton, *supra* note 2, 1394.
[169] *Ibid.* (nonfinancial firms generally); Gregory Zuckerman, "Big Shareholders Are Shouting Larger Than Ever", Wall Street J., November 23, 2005, C1 (S&P 500).
[170] Bratton, *supra* note 2, 1394; Zuckerman, *supra* note 169.

EACH MONTH)



Source: Derived from figures available on Yahoo! Finance

Ownership structure is a second element of the supply side that likely helped to promote shareholder activism by hedge funds in the 2000s. The received wisdom is that a separation of ownership from control in public companies is a hallmark of U.S. corporate governance.[171] While some question just how prevalent dispersed share ownership in fact is in U.S. public companies,[172] there is little doubt share ownership was more diffuse in 2000 than in 1900.[173] This trend should have in turn bolstered the supply side of the market for corporate influence, but it is unlikely that ownership dispersion was markedly greater in the 2000s than it was in the 1990s. Correspondingly, variation on this count likely does not help to explain the growing prominence of shareholder activism by hedge funds. On the other hand, the composition of the shareholder base and its receptivity to activist initiatives likely did play a role.

The proportion of shares of U.S. public companies held by domestic institutional investors rose from 14% in 1965 to 45% in 1985 and again to 65% in 2002.[174] This potentially could have put a damper on shareholder activism, as institutional shareholders were traditionally anything but reliable backers of those challenging management. Indeed, in 1986 the *Wall Street Journal* suggested "institutions are the worst constituency a dissident could have", citing a money manager who said "institutions vote for you if you're a sure winner. If you're not, they'd rather remain on good terms with management" to ensure they could discuss "the latest earnings report".[175]

Fast-forward to the early 2000s. The new wave of hedge fund activists, eager to increase their

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[171] See, for example, James P. Hawley and Andrew T. Williams, *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic* (Philadelphia: University of Pennsylvania Press, 2000), 42.

[172] Clifford G. Holderness, "The Myth of Diffuse Ownership in the United States", (2009) 22 Rev. Fin. Stud. 1378 (providing data indicating that a sizeable majority of U.S. public companies have a blockholder with a large minority stake).

[173] For a survey of the relevant literature, see Brian R. Cheffins and Steven A. Bank, "Is Berle and Means a Myth?", Bus. Hist. Rev., forthcoming.

[174] O'Sullivan, *supra* note 106, 156; Marcia Vickers, "The Ultimate Value Investors", Business Week, June 10, 2002, 124.

[175] Linda Sandler, "Firms Face Gripes From New Gadflies", Wall Street J., May 19, 1986, 23.

leverage with management, regularly sought to rally major institutional shareholders to back their dissident campaigns.[176] Key money managers proved to be much more receptive than in the past, with the bear market following the collapse of the dot.com stock market boom providing the catalyst for the change. *Institutional Investor* said in 2003 of the change of heart "A gruelling, two-year bear market is probably the biggest factor: What companies could get away with when most stocks were rising is no longer acceptable when they are plunging."[177]

Crucially, key institutional investors did not revert to old habits when share prices swung upwards. As a New York M&A lawyer said in 2006, "You have establishment institutions that now think they have to be proactive."[178] The *New York Times* spelled out the implications, saying "the greatest shift in the influence that activist shareholders have gained is the role once-conservative institutional investors – big money managers like the mutual fund giant Fidelity – have begun to take."[179] This did not mean leading money managers were taking the initiative; they still preferred to retain the option to cut their losses by selling shares in underperforming companies and to avoid the adverse publicity that confronting public company executives could generate.[180] Still, to a greater extent than had been the case previously, key institutional investors were prepared to offer backing to activists prepared to do the dirty work, thus lending valuable credibility to campaigns to challenge managers of target companies.[181]

C. Demand Side

On the demand side, financing costs constitute a potential deterrent to offensive shareholder activism, given that buying up a sizeable stake in a publicly traded company is typically an expensive proposition (see Part II.A.2). Explosive growth in the hedge fund sector left hedge funds well-placed financially to step forward as dominant players in the market for corporate influence in the decade or so leading up to the financial crisis. The "seismic boom" beginning in the 1990s continued unabated at the start of the 2000s, and by 2006 there were 8,000 hedge funds managing assets of well over $1 trillion.[182] This sizeable pool of capital was more than ample to fund offensive shareholder activism on a reasonably wide scale, even if only a small sub-set of hedge funds actually engaged in activism (Brav *et al.* found 236 doing so between 2001 and 2006).[183]

One factor that contributed to the dramatic expansion of the hedge fund sector was deregulation of requirements concerning investor eligibility to invest in hedge funds.[184] Hedge funds operate largely outside U.S. federal securities regulation by taking advantage of exemptions granted for "private investment companies".[185] The core exemption is found in section 3(c)(1) of the Investment Company Act of 1940, which excludes from the scope of the legislation funds that do not make a public offering of their securities and do not issue securities to more than 100 investors.[186] Reliance on this exemption traditionally was problematic because a fund manager was required to make a subjective determination that each purchaser had sufficient experience to evaluate the risks involved and had sufficient financial wherewithal to accommodate the potential downside.[187] In 1982,

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176 Justin Schack and Steven Brull, "The Little Shareholder That Could", Institutional Investor, April 2002, 33.

177 *Ibid.* See also James Surowiecki, "Gadfly Inc.", September 10, 2001, 42.

178 Andrew Ross Sorkin, "To Battle, Armed With Shares", N.Y. Times, January 4, 2006, C1.

179 *Ibid.*

180 Daniel Gross, "Some Mutual Funds Are Joining the Activist Bandwagon", N.Y. Times, January 15, 2006, C5.

181 Vickers, *supra* note 174.

182 Partnoy and Thomas, *supra* note 138, 24.

183 Brav *et al.*, *supra* note 2, 1739.

184 Greupener, *supra* note 139, 1562-63.

185 S.E.C. Staff Report, *supra* note 138, 11-13.

186 15 U.S.C. §§ 80a-3(c)(1).

187 Securities and Exchange Commission, "Prohibition of Fraud by Advisers of Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles", Release No 33-8766, 15 (Dec. 27, 2006),

however, the S.E.C. introduced a "safe harbour" rule for private investment companies that did not involve such subjective determinations, with the exemption being dependent upon securities being issued only to "accredited investors" with a net worth of over $1 million or an annual income of at least $200,000.[188]

When the "accredited investor" safe harbour was introduced, approximately 1.9% of U.S. households qualified for accredited investor status but with the thresholds remaining the same, due to inflation and sustained growth in wealth and income, by 2003, an estimated 8.5% of households qualified.[189] While this trend theoretically expanded the pool of capital available for investment funds inclined to engage in activism, it is unlikely introduction of this safe harbour contributed materially to the emergence in the 1980s of the activist-oriented private investment funds that were the antecedents to the hedge fund activists of the 2000s. For hedge fund sponsors the effort involved with determining suitability as an "accredited investor" meant the costs associated with targeting retail investors just above the threshold outweighed the benefits of investments such investors might make.[190]

Further de-regulation in 1996 likely had a greater practical impact.[191] Hedge fund sponsors found the 100 investor exemption difficult to work with, so Congress, reasoning that highly sophisticated investors did not need the protection of the Investment Company Act of 1940, created a new exemption.[192] The new rule, set out in section 3(c)(7) of the legislation, exempted from the Act funds issuing securities only to "qualified purchasers", defined to include individuals owning more than $5 million worth of investments or managing assets of greater than $25 million.[193] With this exemption there technically was no maximum number of investors, but hedge funds typically capped participation at 499 so as to avoid registration and reporting requirements under the Securities and Exchange Act of 1934.[194]

One result of the 1996 change was that it helped to facilitate institutional investor participation in the hedge fund sector. Institutional investors paid little attention to hedge funds until the 1980s, when the Yale endowment fund began investing seriously in the sector.[195] Even as of 1993 institutional money made up only 5% of hedge fund assets. However, this figure ballooned to roughly 25% in 2001,[196] with the 1996 rule changes meaning dozens of institutional investors could invest in a single hedge fund without giving rise to concerns the Investment Company Act of 1940 would come into operation.

Market trends worked in tandem with deregulation to foster institutional investment in the hedge fund sector. The slump in stock prices occurring at the beginning of the 2000s created pressure for those managing assets on behalf of pension funds, endowments and charitable foundations to look beyond the stock market for satisfactory investment returns, and this in turn led them to hedge funds, which were regularly outperforming mutual funds.[197] A further attraction was that hedge funds could theoretically reduce overall portfolio risk by creating a level of diversification well above that which

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available at http://www.sec.gov/rules/proposed/2006/33-8766.pdf.

[188] Regulation D, rule 501(a). See Securities Act Release No. 6389 (Mar. 8, 1982).

[189] S.E.C. Staff Report, *supra* note 138, 80; Securities and Exchange Commission, *supra* note 187, 24.

[190] S.E.C. Staff Report, *supra* note 138, 80-81.

[191] Greupener, *supra* note 139, 1562-63.

[192] National Securities Markets Improvements Act of 1996, Pub. L. No. 104-290; for background see S.E.C. Staff Report, *supra* note 138, 12-13; Charles J. Gradante and E. Lee Hennessee, "The National Securities Markets Improvements Act of 1996—Defining Moment for the Hedge Fund Industry?", available at http://www.hennesseegroup.com/Featured_Articles/defining_moment.html .

[193] 15 U.S.C. §§ 80a-3(c)(7). On who is categorized as a qualified purchaser, see S.E.C. Staff Report, *supra* 138, 12, n. 37.

[194] S.E.C. Staff Report, *supra* 138, 13; Greupener, *supra* note 139, 1562.

[195] Steven Brull, "Hedge Fund Holdouts", Alpha, November 2005.

[196] Michael Dubes, "Hedge Funds: Worth a Closer Look?", Fin. Executive, September 2001, 49.

[197] *Ibid*.; Chris Clair, "'Unprecedented Pressure': Public Plans Race to Embrace Hedge Funds", Pensions and Investments, July 8, 2002, 2.

investors could get by relying on traditional asset classes.[198] Accordingly, pension fund and endowment investment in hedge funds increased from $15 billion in 2000 to $100 billion in 2004.[199] Likewise, the proportion of assets allocated to hedge funds by U.S. pension funds, endowments and foundations rose steadily from 1.6% in 2004 to 2.6% in 2007.[200]

Market trends fortified activism by hedge funds in another way in the mid-2000s. As Part II.C.1 discussed, if debt can be obtained readily and cheaply, a hedge fund manager aiming to engage in offensive shareholder activism will be well-positioned to boost available financial firepower by borrowing. During the mid-2000s, the conditions were optimal for adopting this strategy. Low interest rates combined with historically small differentials between high-yield and investment-grade debt to mean borrowing was very "cheap" by historical standards.[201] Debt was also plentiful, due to liberal lending by banks and a booming market for credit derivatives hedge funds dominated.[202]

Cheap debt also meant that companies could accede to shareholder demands more readily than would have been the case in a tight credit market. During the mid-2000s, hedge fund activists commonly agitated for a target company to make a big cash payout, dispose of underperforming divisions or put itself up for sale.[203] With borrowing being cheap, it was relatively painless for target companies to respond by taking on more debt to distribute cash to shareholders and to find buyers for subsidiary operations. Even putting an entire company up for sale could be fairly straightforward, particularly with private equity firms using leverage to carry out buyouts at an unprecedented rate.[204] Hence the credit "bubble" that built up in mid-2000s provided hedge funds with an ideal environment in which to agitate for change.[205]

Transaction costs, as with financing costs, help to shape the demand side of the market for corporate influence. Transaction costs include, in addition to the expenses associated with buying and selling shares, communication costs activist shareholders incur as they seek to gain support from otherwise neutral investors (see Part II.A.2). Regulatory changes the S.E.C. introduced in 1992 reduced communication costs considerably, which meant that when hedge funds were otherwise prepared to move to the forefront as shareholder activists they could operate in a congenial environment as they targeted underperforming companies.

The S.E.C.'s 1992 reforms were intended to facilitate communication among shareholders by cutting back on instances where there had to be compliance with requirements imposed on parties seeking change through the proxy process, most notably an obligation to file relevant documentation for review by the S.E.C.[206] For instance, a safe harbour was created for all oral communications and for discussions among fewer than ten investors, an exemption activists could rely upon to lobby privately in favour of their initiatives.[207] Advertisements, speeches and statements in the media were also given a safe harbour, as were communications by "disinterested parties" who were expressing views on public companies but were not actively soliciting votes from other investors (shareholders owning more than $5 million in shares were deemed not to qualify).[208]

According to one study of hedge fund activism, the 1992 changes were "revolutionary", because

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[198] Brull, *supra* note 195; Dubes, *supra* note 196.

[199] Riva D. Atlas and Mary Williams Walsh, "Pension Officers Putting Billions into Hedge Funds", N.Y. Times, Nov. 27, 2005, 1.

[200] PrivateEquityWire, "US Institutions Expanding Allocation to Alternatives, Says Greenwich Report", May 2, 2008.

[201] Steven Rattner, "The Coming Credit Meltdown", Wall St. J., June 18, 2007, A17.

[202] *See* Richard Beales, "Hedge Funds Lead US Junk Sector Lending", Fin. Times, April 2, 2007, 17; "In the Shadows of Debt", Economist, Sept. 23, 2006, 84.

[203] *Supra* note 42 and related discussion.

[204] Cheffins and Armour, *supra* note 38, 23-24.

[205] Peter Thai Larsen, "Life After the Golden Age", Fin. Times, September 10, 2007, FT fm, 9.

[206] Pound, *supra* note 35, 1041; Joseph Evan Calio and Rafael Xavier Zahralddin, "The Securities and Exchange Commission's 1992 Proxy Amendments: Questions of Accountability", (1994) 14 Pace L. Rev. 459, 488-89, 495-96.

[207] Conference Board, *supra* note 41, 32-33.

[208] Calio and Zahralddin, *supra* note 206, 495, 497-98.

"(r)estrained only by the general proxy antifraud rule, a hedge fund activist (was) now free to disseminate to the world near telephone books full of essentially unverifiable presentation slides."[209] Even though hedge funds did not move into the forefront as shareholder activists until the early 2000s, the effect of the reforms was already being felt in the 1990s. A *Fortune* report on Michael Price's much-heralded 1996 activist campaign against Chase Manhattan said the "1992 change in the rules governing institutional shareholders helped unleash Price", as he took advantage of the safe harbours available to contact and attempt to win over major Chase Manhattan shareholders.[210] Likewise, a 1996 article in *Investor Relations* on activist hedge fund Greenway Partners noted the 1992 rule change meant the firm could "communicate with other shareholders without complicated legal advice and paperwork filed with the S.E.C. That's important, given the reputation Greenway has earned for frugality, which extends from the fees they charge investors to the home-made graphics on their shareholder letters."[211] Similarly, a 1998 *Wall Street Journal* report on a growing number of instances of shareholder activists buying up stakes in underperforming companies quoted the deputy director of the Council of Institutional Investors as saying of the 1992 S.E.C. reform package, "it really paved the way for real communication between shareholders and management."[212]

A "gap" in S.E.C. disclosure rules also proved congenial to hedge fund activism. For shareholder activists the benefits they derive from their efforts will typically be measured not by the proportion of the shares owned as the activism campaign proceeds, but at the time the market first becomes aware of the activist's involvement (see Part II.A.3). Regulation plays a potentially pivotal role in this context, with the key rule under U.S. federal securities law being Rule 13d, which again requires investors who acquire a stake of 5% or larger in a publicly traded company to disclose their stake promptly. When Rule 13d was introduced in 1968,[213] derivatives known as "swaps" that facilitate the decoupling of economic exposure from voting rights normally associated with shares did not exist, meaning the disclosure rules were not drafted with such instruments in mind. [214] Correspondingly, it became accepted market practice, based on reasonably well-settled law, for investors who owned fewer than 5% of the shares of a publicly traded company and relied on over-the-counter derivatives to acquire an economic stake exceeding the 5% level to refrain from divulging their positions under federal securities law.[215] The received wisdom concerning Rule 13d meant that a hedge fund could theoretically build up an economic stake substantially exceeding the statutory 5% threshold and thereby increase b_i without carrying out the mandated disclosure that would lead other investors to buy up shares, drive up the share price and cap the upside to be captured by intervention. Correspondingly, shareholder activism would have been worthwhile in a wider range of instances than would have been the case if disclosure had been required.

V. HEDGE FUNDS AND OFFENSIVE SHAREHOLDER ACTIVISM – FUTURE TRENDS

Prediction is a risky game. Those prescient enough to predict the recent financial crisis was in the cards were treated as Cassandras beforehand.[216] Regardless, it seems a safe bet that offensive shareholder activism will remain an element of U.S. corporate governance going forward. On the "supply side" of the market for corporate influence, there should always be underperforming companies with a sufficiently dispersed ownership structure to mean $b_i > 0$. On the demand side,

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[209] Briggs, *supra* note 72, 687.

[210] Serwer, *supra* note 149.

[211] Bennett and Stewart, *supra* note 145.

[212] Greg Ip, "As Activists Flex Muscles, Bull Charges Ahead", Wall Street J., June 8, 1998, C1.

[213] Pub. L. 90-439, 82 Stat. 454 (July 29, 1968). In 1970 the ownership threshold bringing Schedule 13D into operation was reduced from 10% to 5%: Pub. L. No. 91-567, 84 Stat. 1497.

[214] Hu and Black, *supra* note 68, 815, 844, 870-71.

[215] *Ibid.*, 868; letter from Brian Breheny, Deputy Dir., S.E.C. Division of Corporate Finance, to Judge Lewis A. Kaplan, U.S. Dist. Court Judge, S. Dist. of N.Y. (June 4, 2008), available at www.gibsondunn.com/publications/Documents/CSX-BrianBrehenyLtrToJudgeKaplan.pdf .

[216] Aaron Pressman, "A Season for Cassandras", BusinessWeek Online, August 24, 2007.

despite various costs that act as potential deterrents to offensive shareholder activism, there have been instances where $c_i < \alpha\ b_i$ extending back to the 19th century and, given how transaction costs and search costs have dropped dramatically over time, there no doubt will be instances going forward where this will be the case.

While offensive shareholder activism likely is a permanent feature of U.S. corporate governance, it is unclear at this point whether the hedge fund-driven surge that occurred in the 2000s will be sustained going forward or was an aberration fuelled by exceptional market conditions. Nevertheless, the analysis we have offered to this stage provides the platform for plausible conjectures since the elements of the market for corporate influence identified in Part II likely will dictate how matters proceed. We will begin by discussing levels of hedge fund activism during the financial crisis.

A. The Financial Crisis and Shareholder Activism by Hedge Funds

As will be the case with pretty much any aspect of the corporate governance of public companies over the next few years, shareholder activism trends need to be analyzed through the prism of the recent financial crisis. Did the market turmoil bring to an end the surge in offensive shareholder activism hedge funds prompted? The available evidence is somewhat conflicting.

According to data compiled by Thomson Reuters, the number of activist campaigns in U.S. public companies fell from 61 in 2007 to 34 in 2008, with just two interventions occurring during the final quarter of 2008.[217] On the other hand, Georgeson listed in its annual review of shareholder activism for 2008 56 contested proxy solicitations, 31 of which were led by 18 different hedge funds, all totals which were higher than in 2007 (46, 20 and 16 respectively).[218] In addition, data on companies targeted by shareholder activists compiled monthly by the Official Activist Investing Blog from Hedge Fund Solutions' weekly *Catalyst Equity Research Report* indicates activism levels held up well between September 2008 and March 2009, when the financial crisis was its most acute (Fig. 3).[219] However, in the months following the number of companies targeted dropped steadily.

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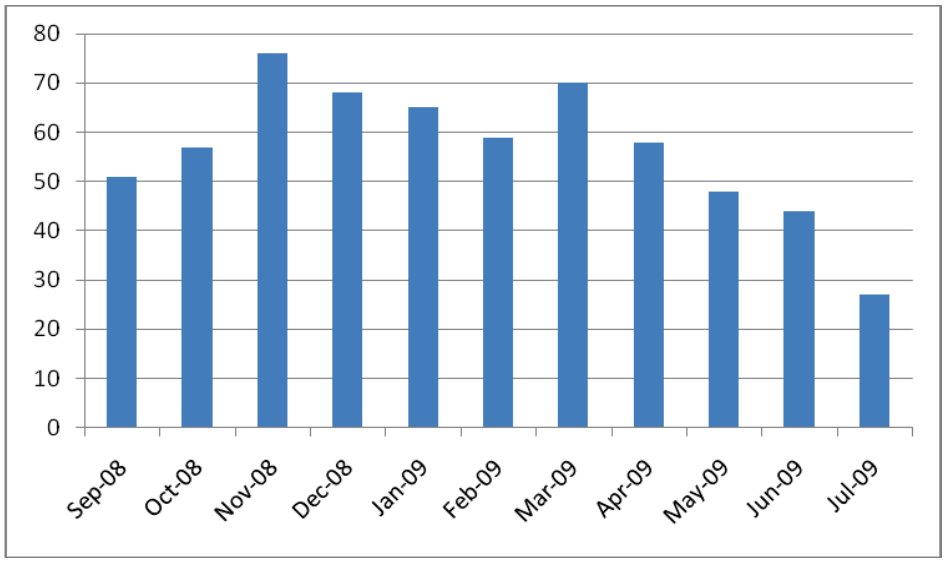
[217] "Flight of the Locusts", Economist, April 11, 2009.

[218] On 2007, see *supra* note 159 and accompanying text. The hedge funds initiating contested proxy solicitations in 2008 were Western Investments LLC (four instances), Bulldog Investors, Carl Icahn *et al.*; Costa Brava Partnership III, Harbinger Capital Partners, Oliver Press Partners, Ramius Capital Group, Steel Partners II (two instances), Children's Investment Fund, Crescendo Partners/Myca Partners, Harbinger Capital Partners, Laxey Partners Ltd., Lion Fund, OSS Capital Management, Outpoint Capital, Palisair Capital Partners, Shamrock Activist Value Fund, Sun Capital Partners. See Georgeson, *2008 Annual Corporate Governance Review: Annual Meetings, Shareholder Initiatives, Proxy Contests* 46-47 (2009).

[219] See http://activistinvesting.blogspot.com/ ; monthly archives. Data is only available back to September 2008 because the blog was launched in the summer of that year.

FIGURE 3: COMPANIES TARGETED BY ACTIVIST SHAREHOLDERS, SEPTEMBER 2008-JULY 2009



Source: Official Activist Investing Blog

B. Supply Side

How robust is offensive shareholder activism likely to be going forward, assuming the buoyant stock prices and cheap borrowing that characterized the mid-2000s will not be features of financial markets, at least in the near term? Elements on both the supply side and demand side of the market for corporate influence seem likely to come into play.

On the supply side, to the extent shares continue to trade at prices substantially below levels reached in the mid-2000s, shareholder activists are likely to encounter numerous instances where there is a potentially sizeable discrepancy between share prices and the intrinsic value of the underlying business.[220] As the *Financial Times* observed in 2008, "the recent share price fall will provide an opportunity for those funds which want to buy into companies cheaply and try to engineer change."[221] Moreover, so long as share prices remain in the doldrums as compared with the mid-2000s, public companies will find it hard to cover up poor share price performance because they will not be able to count on any sort of boost from general stock market trends.[222] Companies in turn could well have restive shareholders receptive to activist overtures.[223] Senior executives, in addition, are likely to be on the defensive with the financial crisis having eroded confidence in corporate leadership, and thus will be susceptible to investor demands.[224] The upshot is that various features of the post-financial crisis market environment imply there should be numerous instances where $c_i < \alpha\ b_i$.

On the other hand, as a *Financial Times* columnist put it in 2007 as the credit crunch that set the scene for the financial crisis hit, "Activist investors may find they have a greater choice of legitimate

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[220] Eric Jackson, "Why 2009 Will Bring More Activism", TheStreet.com, Dec. 11, 2008; Ken Squire, "A Golden Age for Activist Investing", Barron's, February 16, 2009.

[221] "Long Live Activism", Fin. Times, November 5, 2008, 12.

[222] Larsen, *supra* note 205; Squire, *supra* note 220.

[223] "Winners and Losers", *supra* note 45; Squire, *supra* note 220; William Hutchings, "Activists Defy the Market Downturn", Fin. News, June 23, 2008.

[224] Jackson, *supra* note 220; Squire, *supra* note 220; "Long Live", *supra* note 221.

targets, but fewer tools to work with."[225] While the cheap debt of the mid-2000s provided activists with market conditions well-suited for lobbying target companies to distribute cash to shareholders or put the business up for sale, in a more austere debt environment, it is "harder to persuade boards to gear up balance sheets with debt or push companies into the arms of prospective bidders."[226] As a shareholder activist said in 2009, "In any deal you do, you're always looking for multiple exit strategies – those are limited in the current market."[227] Activism campaigns therefore will likely have to focus on improving strategy and operations rather than financially oriented initiatives, a potentially unappealing prospect for many hedge fund activists.[228]

Compounding matters, activist shareholders will not be able to take for granted shareholder backing for the challenges they launch. While a share price slump will prompt investor dissatisfaction, shareholders who might have been willing to back activists in good times may fear disrupting the status quo in less stable economic conditions. As special counsel for RiskMetrics Group, parent company of proxy advisor I.S.S. Governance Services, said of the 2008 proxy season at U.S. public companies, "Concerns about the market and economy trumped concerns about individual management or boards. The irony here is management and boards may have benefited from how bad the market was."[229] Likewise, as an investor familiar with an unsuccessful 2009 proxy battle launched by hedge fund Pershing Square against discount retailer Target said, "Conservatism is a big problem. Big long-only investors (i.e. major mutual funds and pension funds) don't want to know about unlocking value right now. They're still just concentrated on preserving it."[230] Correspondingly, the market turmoil associated with the financial crisis could ultimately discourage offensive shareholder activism despite shares of potential targets being "cheap" by historical standards.

Though it is unclear what impact recent market trends will have on the supply side of the market for corporate influence, legal reforms that enhance shareholder rights against incumbent directors could provide a boost.[231] Regulatory change can have an impact in this context by increasing the proportion of underperforming public companies where shareholder activists can credibly challenge the incumbent management team. The discussion of the supply side of the market for corporate influence in Part II.B.1 drew attention to the pattern, indicating that 2009 S.E.C. changes to rules governing proxy voting by stockbrokers in uncontested director elections could foster offensive shareholder activism by making it easier for dissident shareholders to shape the composition of the board.

Another anticipated reform that will likely have a similar effect involves giving insurgent shareholders seeking board seats access to the corporate proxy machinery utilised by management. As Part IV.A. discussed, lobbying by the corporate community derailed a 2003 S.E.C. proposal on this issue. In June 2009, however, the S.E.C. returned to the fray, releasing proposed proxy access rules that would give shareholders owning a prescribed percentage of shares in a public company (1%, held for a period of one year, in the case of companies with a market capitalization of $700 million or more) the right to rely on the company's proxy materials to propose candidates for election to the board.[232] The Shareholder Empowerment Act of 2009, introduced to the House of Representatives by Gary Peters the same month, contains a similarly structured provision.[233]

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[225] Larsen, *supra* note 205.

[226] Kate Burgess, "Activists Flex Muscles as Markets Falter", Fin. Times, January 8, 2008, 19.

[227] Sam Jones and Lina Saigol, "Activist Investors Eye Smaller Prey in Tricky Climate", Fin. Times (Asia ed.), July 23, 2009, 13.

[228] Eric Jackson, "Activist Investors Sidelined by Brutal Market", The Street.com, April 6, 2009.

[229] Kristen Gribben, "Shareholder Democracy is on Hold", Fin. Times, July 7, 2008, FT fm, 9.

[230] Sam Jones, "Activist Funds Find Going Tough", Fin. Times, August 31, 2009, 19.

[231] Jackson, *supra* note 220.

[232] Securities and Exchange Commission, "SEC Votes to Propose Rule Amendments to Facilitate Rights of Shareholders to Nominate Directors", S.E.C. Release 2009-116 (available at http://www.sec.gov/news/press/2009/2009-116.htm, accessed June 18, 2009).

[233] Shareholder Empowerment Act of 2009, § 2, available at http://www.govtrack.us/congress/billtext.xpd?bill=h111-2861.

Many in the corporate community continue to oppose liberalized access to the corporate proxy machinery, citing the potential for abuse by dissident shareholders with interests reputedly contrary to shareholders generally.[234] However, with the financial crisis having prompted discontent with the jobs done by corporate boards the likelihood of implementation of proxy access reform is greater than it was in 2003.[235] If a rule similar to that proposed by the S.E.C. is in fact brought into force, hedge funds engaging in offensive shareholder activism would likely often satisfy the share ownership criteria, which in turn would leave them well-positioned to extract concessions in deals with incumbent executives eager to avoid a fully fledged proxy fight.[236] To the extent this is the case, reform should encourage offensive shareholder activism.

C. Demand Side

While there are features of the supply side of the market for corporate influence that in the near- to medium-term could encourage shareholder activism by hedge funds, the trend appears to be different on the demand side. Financing costs help to shape the demand side because it will typically be expensive to acquire a sizeable minority stake in a publicly traded company and because shareholder activists will be better positioned to engineer change at a target company if they have the financial resources required to launch a proxy fight should quiet negotiations fail to prompt desired results (see Part II.A.2). As has been discussed (see Part IV.C.), in the 2000s "cheap" debt and the "seismic boom" the hedge fund industry experienced meant that the deep pockets constraint impinged less on shareholder activism than had been the case in previous decades. The recent financial turmoil has, however, complicated matters.

A key feature of the financial crisis was that the credit "bubble" of the mid-2000s was replaced by a credit crunch. For hedge funds that relied on borrowing as an element of their investment strategy, a by-product was increased funding costs, as credit spreads (the additional net yield an investor can earn from a risky security relative to a "risk-free" security) rose well above typical historic levels.[237] Even if credit spreads return to "normal" in the near-to-medium term, a cheap debt renaissance seems unlikely. Hedge fund managers with an appetite to engage in shareholder activism correspondingly will not be able to use debt to side-step financial constraints as readily as they could when hedge fund activism rose to prominence in the early and mid-2000s.

The financial crisis also ended the hedge fund industry's "seismic boom". In 2008, hedge funds as an asset class posted their first double digit loss in history, reflected by a 19.1% decline in the Credit Suisse/Tremont Hedge Fund Index.[238] Due to a combination of trading losses and withdrawals by nervous investors, total assets under management by global hedge funds fell from $1.93 trillion in June 2008 to $1.5 trillion by the end of 2008 and $1.3 trillion by mid-2009.[239] Moreover, hedge funds specializing in shareholder activism were among those worst affected during the market turmoil.[240] Activist hedge funds suffered because they tend to hedge less than other hedge funds, meaning they were fully exposed to the falling stock prices that characterized 2008, and because the small and mid-cap companies in which they typically invest suffered outsized share price declines as compared with large cap companies.[241] Major activist hedge funds correspondingly experienced, even by the dismal

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[234] Floyd Norris, "With Power, the Risk of Abuse", N.Y. Times, July 17, 2009; Jeffery McCracken and Kara Scannell, "Fight Brews as Proxy-Access Nears", Wall Street J., August, 26, 2009.

[235] Norris, *supra* note 234.

[236] *Ibid*.

[237] Credit Suisse/Tremont Hedge Fund Index, "One For the History Books: Hedge Fund Performance in 2008", January 2009, 6.

[238] *Ibid*., 1, 3; the index was launched in 1994.

[239] Nancy Trejos, "Hedge Fund Industry's Role in Wall St. Crisis", Washington Post, October 25, 2008, D3 (June 2008 figure); Credit Suisse/Tremont Hedge Fund Index, *supra* note 237, 1 (end of 2008); Credit Suisse/Tremont Hedge Fund Index, "1H 2009 Hedge Fund Update: Halfway There", July 2009, 1.

[240] "Long Live", *supra* note 221.

[241] Jackson, *supra* note 228; Helen Fowler, "The Changing Face of Investor Activism", Fin. News, June 15,

standards of the hedge fund industry, heavy losses and sizeable redemption demands.[242]

For instance, the value of Steel Partners' flagship activist fund fell 39% in 2008 and by mid-2009 assets under management were half what they were at the beginning of 2008.[243] Cerberus Capital had received by mid-2009 redemption requests for $5.5 billion for its $7.7 billion activist hedge fund portfolio.[244] Carl Icahn, whose activist hedge fund was down 36% in 2008, contributed $500 million of his personal fortune to his fund to meet redemption requests.[245] Even Jana Partners, an activist hedge fund which had relatively good returns during the financial crisis, was hit with redemption requests approaching 30% of assets.[246]

Various major activist hedge funds, suddenly finding themselves with markedly less deep pockets as a result of the market turmoil, have been struggling to assemble the financial firepower to take on new targets and have tended to focus instead on working out existing investments.[247] In a number of instances, hedge funds have prematurely exited companies in which they had invested significant time and money securing directorships (e.g. Relational Investors with the telecommunications company Sprint Nextel), with the goal seemingly being to focus on a smaller set of investments within their portfolio.[248] Moreover, recent events have disillusioned leading players in the activism field. The Children's Investment Fund (TCI) was allowing investors in 2009 to withdraw some of their money ahead of a previously agreed "lock-up" period,[249] not long after its founder Christopher Hohn -- widely regarded as one of the top activist investors in the world -- complained in 2008 that activism was "hard" and "unpredictable and expensive", citing a bitter proxy battle with CSX, a railway company, where CSX's shares plummeted after TCI spent more than $10 million winning four board seats.[250] Tim Barakett, founder of Atticus Capital and reputedly "one of the fathers of modern hedge fund activism,"[251] closed in 2009 the two big Atticus funds under his management after assets invested plunged from $20 billion at the beginning of 2008 to $5 billion.[252]

The market trends that helped to prompt the emptying of hedge funds' deep pockets are unlikely to continue unabated. A partial hedge fund rebound occurred during the first half of 2009, with the hedge fund asset class posting returns of 7.2% during the first half of 2009 (the S&P 500 stock market index rose 3.2%) and many of the world's larger hedge funds were experiencing net inflows by mid-2009.[253] However, even if market conditions continue to improve the financial crisis could yield a regulatory legacy that impinges on the demand side of the market for corporate influence by increasing the transaction costs associated with activism.

Hedge funds have at least to some extent been blamed for the financial crisis.[254] As Lorenzo Bini-Smaghi, an executive board member of the European Central Bank, said in 2009, "whoever was not regulated before does not want to be regulated and talks of over-regulation, but the fact they weren't regulated was one of the causes of the crisis."[255] It is in fact doubtful whether hedge funds

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2009.

[242] Jackson, *supra* note 228.

[243] Steve Johnson, "Activist Investor Settles Into New Bank Chairman Role", Fin. Times, August 17, 2009, 16.

[244] Jones, *supra* note 230.

[245] Jackson, *supra* note 228; Zachery Kouwe, "Among Activist Investors, a New Hesitancy", N.Y. Times, March 26, 2009.

[246] Jackson, *supra* note 228.

[247] "Flight of the Locusts", *supra* note 217; Jackson, *supra* note 228; Jones, *supra* note 230.

[248] Jackson, note 228.

[249] Jones, *supra* note 230.

[250] Jackson, *supra* note 228; Kouwe, *supra* note 245.

[251] "Activist Hedge Funds", Fin. Times, August 13, 2009.

[252] Gregory Zuckerman and Jenny Strasburg, "Atticus Capital to Close Two Big Funds", Wall Street J., August 12, 2009, C1.

[253] Credit Suisse/Tremont Hedge Fund Index, "1H", *supra* note 239, 2 (data); Sam Jones, "Hedge Funds Buoyant as Assets Under Management Surge", Fin. Times, July 22, 2009, 20 (inflows).

[254] Christine Williamson, "Industry Bracing for Round of Congressional Regulation", Pensions & Investments, February 23, 2009, 4.

[255] Quoted in Melvyn Krauss, "Don't Blame Hedge Funds", International Herald Tribune, June 25, 2009, 8.

played a significant role in precipitating the financial crisis.[256] Far more obvious culprits, at least in the U.S., were the Federal Reserve (its interest rate policies helped to create the housing "bubble" of the 2000s that was at the epicentre of the financial crisis), banks (they made the dubious loans to people who could not afford the houses they were buying and then packaged up, sliced and sold these loans on to other financial institutions) and home buyers (they borrowed imprudently on the assumption house prices could only go up).[257] Regardless, with legislators and regulators largely convinced there is a need to regulate hedge funds in the aftermath of the financial crisis, it is widely acknowledged that regulatory oversight of the hedge fund sector will increase.[258]

What is not clear at this point is the shape reform will take. As a result, it is too early to say whether hedge funds will face constraints on their operations and trading strategies that will handicap their ability to engage in offensive shareholder activism. The European Commission has issued a proposed directive on alternative investment fund managers that has been characterized as "a killer blow for the hedge fund industry."[259] However, 80% of hedge funds are U.S.-based and will not be bound by measures the European Union adopts,[260] meaning it is domestically generated reforms that will matter.

It is likely federal securities law will be amended to require hedge fund managers whose assets under management exceed a modest threshold (expected to be $30 million) to register with the S.E.C. as investment advisers under the Investment Advisers Act of 1940.[261] Given that more than half of U.S. hedge fund managers are already registered with the S.E.C. and given that any hedge fund, whether registered or not, that manages $100 million or more already has to report its holdings quarterly by filing a Form 13F with the S.E.C., reform of this sort would create some inconvenience for hedge funds but should not impinge greatly on their operations.[262] What is not clear is whether registration would open the door for additional regulation that would have this effect. Jack Reed, chairman of the Senate Banking subcommittee on securities, insurance and investment, has said hedge fund oversight should possibly extend to mandating leverage, capital and risk management standards.[263] Regulation of this nature potentially could increase c_i markedly for hedge fund managers otherwise inclined to engage in shareholder activism, thereby impinging on the demand side of the market for corporate influence.

Future regulatory reforms aside, a 2008 judicial ruling arising from TCI's proxy battle with CSX likely will hamper the ability of hedge funds to use derivatives to increase the benefits derived from offensive shareholder activism, thereby discouraging activist funds from stepping forward. TCI, joined by 3G, another activist hedge fund, commenced a proxy fight in which they sought to elect at CSX's 2008 annual shareholder meeting five directors to CSX's 12-person board. CSX, in response, filed a suit asserting the proxies TCI had accumulated should be invalidated because of failures by TCI to make proper disclosure under Schedule 13D.

As Part IV.C. discussed, it was accepted market practice in the mid-2000s, based on reasonably

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[256] "Hedging the Blame", Wall Street J. (Europe), March 20, 2009, 10; "Why Did G20 Focus on Hedge Funds?", Int'l. Fin. L. Rev., May 2009; Oliver Kamm, "Blame Incompetent Bankers, Not the Rules", Times, June 18, 2009, 29.

[257] Krauss, *supra* note 255. On the role of home buyers, see Justin Fox, "Pointing Fingers: The Financial Crisis Blame Game -- 8. You and Me", http://www.time.com/time/specials/packages/article/0,28804,1869041_1869040_1869037,00.html (accessed August 16, 2009).

[258] Williamson, *supra* note 254.

[259] William Hutchings, "How Would it Work: The Directive in Detail", Fin. News, June 29, 2009 (quoting Ian Cullen, a partner at law firm Simmons & Simmons); Commission of the European Communities, Proposal for a Directive of the European Parliament and the Council on Alternative Investment Fund Managers and Amending Directives 2004/39/EC and 2009/…/EC, COM (2009) 207 final (April 30, 2009).

[260] "Hedge Funds Assert Their Case", Global Investor, June 2009.

[261] Gerelyn Terzo, "Play by the Rules, Whatever They Are", Investment Dealers Digest, June 26, 2009, 24.

[262] Joseph Checkler, "If a Hedge Fund Registers with the SEC, Does it Make a Sound?", Dow Jones News Service, May 7, 2009. On Form 13F disclosure requirements, see *supra* notes 67 and 68 and related discussion.

[263] Williamson, *supra* note 254.

well-settled law, that an investor who owned fewer than 5% of the shares of a publicly traded company and relied on over-the-counter derivatives to acquire an economic stake exceeding the 5% level did not need to divulge its position under federal securities law, meaning that a hedge fund could create a sizeable upside by stealth. TCI correspondingly used "total return equity swaps" (TRS), derivatives that gave TCI economic exposure to CSX but not voting rights, to accumulate the functional equivalent of a 16% holding in the company, and postponed disclosure because it only owned outright 4.5% of the shares.[264]

In the ensuing litigation, CSX argued that TCI should have disclosed its *de facto* 16% holding under Schedule 13D. The New York federal court agreed, holding in a forceful opinion that because TCI had entered into its TRS positions as part of a scheme to avoid Schedule 13D disclosure and because TCI had the power to influence the exercise of voting rights by the investment banks acting as the TRS counterparties, TCI should be treated a "beneficial owner" of the underlying shares, thus violating the disclosure requirements.[265] CSX did not get, however, the remedy it was seeking, namely blocking TCI and its allies from using proxies collected.[266] Correspondingly, TCI and its allies were able to secure four seats on the board, including one for Christopher Hohn.[267]

While TCI secured board representation at CSX, the ruling in the case creates a potentially significant stumbling block for activist hedge funds minded to use derivatives to build up economic exposure in their intended targets. Applying the standard set out in the TCI/CSX judgment, a hedge fund seeking to ascertain its disclosure obligations under Schedule 13D will, if it acquires an economic interest in a target company with derivatives similar to the "swaps" TCI relied upon, need to evaluate whether its actions are likely to be perceived as part of a scheme to evade disclosure and whether it will be thought of as exercising substantial influence over the derivative counterparties.[268] Given how derivatives were used beforehand, some maintain the CSX ruling "effectively threw a hand grenade on the trading desks of activist investors."[269] Certainly, hedge fund activists are likely to tread very carefully when relying on derivatives to bolster the potential benefits they anticipate deriving from their activism campaigns, at least until the law is clarified. The diminution of $\alpha\ b_i$ should in turn discourage offensive shareholder activism, at least in some instances.

VI. CONCLUSION

The hedge fund-driven shareholder activism which gained prominence in the 2000s generated a prompt academic response. This paper has put the relevant literature into context by spelling out what is distinctive about the particular form of activism hedge funds have engaged in, by identifying the variables that affect the operation of the market for corporate influence hedge funds have come to dominate and by explaining what prompted the hedge fund-oriented surge in offensive shareholder activism in the 2000s. The paper has also analyzed how matters are likely to develop going forward. As we have seen, offensive shareholder activism in all likelihood will remain a feature of U.S. corporate governance. The impact the financial crisis of 2008 will have on the recent surge of hedge fund activism is more difficult to predict. This paper nevertheless has identified the variables likely to

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[264] CSX Corp. v. The Children's Investment Fund Management (UK) LLP, 562 F. Supp. 2d 511, 549 (S.D.N.Y., 2008).

[265] CSX Corp. 562 F. Supp. 2d 511, 546-49 (S.D.N.Y., 2008). The court also ruled that TCI breached schedule 13D by failing to disclose that it had formed a "group" with 3G (at 553).

[266] This aspect of the decision was affirmed by the Second Circuit without a written opinion: CSX Corp. v. The Children's Investment Fund Management (UK) LLP, 2008 WL 4222848 (Sept. 15, 2008).

[267] "Rethinking Chris Hohn", Institutional Investor (U.S. edition), October 2008; David Berger and Kenneth M. Murray, "As the Market Turns: Corporate Governance Litigation in the Age of Shareholder Activism", (2009) 5 N.Y.U.J. L. & Business 207, 230-31.

[268] Brian T. Sullivan, "*CSX Corp. v. The Children's Investment Fund Management* and the Need for SEC Expansion of Beneficial Ownership", (2009) 87 N.C. L. Rev. 1300, 1317-18.

[269] Ken MacFadyen, "Choose Your Friends Wisely", Investment Dealers Digest, June 30, 2008 (quoting a partner at Dechert, a law firm). See also "Derailed", Economist, June 30, 2008, 102.

dictate the future of the market for corporate influence over the near- to medium-term, thus providing guidance on the extent to which the insights offered by the recent literature on hedge fund activism are likely to remain salient over time.

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