

The New Hedge Fund Activism: Activist Directors and the Market for Corporate Quasi-Control

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Activist hedge funds increasingly seek and secure board representation in public companies. Representation on target boards may signal a longer-term commitment to target companies that can mitigate some of the typical criticisms of traditional hedge fund activism, such as short-termism. Hedge funds may hold shares for longer periods when they obtain board seats and often become heavily involved in corporate strategy and operations. This article argues that the phenomenon of activist board representation has created an active market for corporate quasi-control, defined as power that is greater than influence but that falls short of actual corporate control. It also discusses recent innovations in activist tactics which can promote the market for corporate quasi-control such as ‘wolf pack activism’, where more than one hedge fund descends upon a company, and ‘golden leash’ compensation structures, which incentivise activist appointed directors to increase the share price of target companies.

Keywords: agency costs; company law; corporate governance; golden leash; hedge fund activism; hedge funds; institutional investors; shareholder activism; short-termism; wolf pack

Introduction

“Every decade needs a villain. In the 1980s, it was the corporate raiders. In the 1990s, it was corrupt executives. And in the 2000s it appears to be activist hedge funds”.¹

Routinely attacked for their perceived short-term focus, activist hedge funds have been termed “hit-and-run activists” by Hillary Clinton² and “swarms of locusts” by a German politician.³ Other vocal critics describe hedge funds as “preying”⁴ on companies and exacerbating short-termism, which is described as a “disease that affects American business”.⁵ Senators Elizabeth Warren and Bernie Sanders recently co-sponsored a bill to regulate the “financial abuses being carried out by activist hedge funds who promote short-term gains at the expense of long-term growth”.⁶ But do activist hedge funds truly represent an enemy force? Or is this rhetoric simply

¹ David A Katz and Laura A McIntosh, ‘Corporate Governance; News; Advice on Coping With Hedge Fund Activism’ (2006) 235 New York Law Journal 5, 5.

² Brandon Kochkodin and Caleb Melby, ‘Hillary Clinton Faults ‘Hit-and-Run’ Activist Investors’ *Bloomberg* (New York, 24 July 2015) <<https://www.bloomberg.com/news/articles/2015-07-24/hillary-clinton-faults-activist-investors-hit-and-run-tactics>> accessed 12 February 2018.

³ Franz Müntefering, former Chairman of the Social Democratic Party in Germany, described hedge fund activists as ‘swarms of locusts that fall on companies, stripping them bare before moving on.’ See ‘Locust Pocus’ *The Economist* (London, 5 May 2005) <<http://www.economist.com/node/3935994>> accessed 12 February 2018.

⁴ Martin Lipton, ‘Important Questions about Activist Hedge Funds’ (*The Harvard Law School Forum on Corporate Governance and Financial Regulation*, 9 March 2013) <<http://blogs.law.harvard.edu/corpgov/2013/03/09/important-questions-about-activist-hedge-funds/>> accessed 1 February 2018.

⁵ Martin Lipton, Jay W Lorsch and Theodore N Mirvis, ‘The Proposed “Shareholder Bill of Rights Act of 2009”’ (*The Harvard Law School Forum on Corporate Governance and Financial Regulation*, 12 May 2009) <<https://corpgov.law.harvard.edu/2009/05/12/the-proposed-shareholder-bill-of-rights-act-of-2009/>>, accessed 1 February 2018 and cited in Lucian A Bebchuk, ‘The Myth That Insulating Boards Serves Long-Term Value’ (2013) 113 Columbia Law Review 1637, 1641 and 1649.

⁶ Portia Crowe, ‘Bernie Sanders and Elizabeth Warren are going after activist hedge funds’ *Business Insider* (New York, 18 March 2016), <<http://uk.businessinsider.com/elizabeth-warren-sponsors-activist-hedge-fund-bill-2016-3?r=US&IR=T>> accessed 1 February 2018. The Brokaw Act was originally proposed in March 2016, was re-introduced in August 2017 and is currently under review. See Alon Brav, JB Heaton and Jonathan Zandberg, ‘Failed Anti-Activist Legislation: The Curious Case of the Brokaw Act’ (2018) Working Paper, 5 <<https://ssrn.com/abstract=2860167>> accessed 5 April 2018.

convenient to insulate boards and foster management entrenchment, especially given that the first casualty of hedge fund activism is often the company CEO?⁷

Hedge fund activism in the United States has risen spectacularly from the ashes of the market for corporate control together with institutional investor activism that did not live up to expectations. Commentators cite various reasons for the demise of the hostile takeover after the 1980s, including: aggressive takeover defences, Delaware jurisprudence, anti-takeover legislation, political pressure against leverage, and unfavourable economic conditions (such as the credit crunch of the early 1990s and the collapse of the junk bond market).⁸ New hope for the shareholder movement was heralded when institutional investors, such as pension funds and mutual funds, became more active in the 1990s.⁹ Although there was a rise in institutional investor activism in the 1990s as the market for corporate control declined,¹⁰ such institutions were plagued

⁷ CEO turnover following hedge fund activist intervention appears to be on the increase. In a study of 167 settlement agreements that were reached during activist interventions launched between 2007 and 2011, Bebchuk and others note that 18.6% of CEOs step down within a year after settlement. See Lucian A Bebchuk, Alon Brav, Wei Jiang and Thomas Keusch, 'Dancing with Activists' (2017) Harvard Law and Economics Discussion Paper 906, 15 and 51 <<https://ssrn.com/abstract=2948869>> accessed 12 February 2018. This figure also seems to be increasing as a 2017 report notes that annualised CEO turnover at activist targets has averaged 23% compared to 12% for non-targets (based on CEO departures within one year of campaign launch at US companies with market caps over \$500 million from 2013 to 2017. See Lazard's Shareholder Advisory Group, 'Review of Shareholder Activism – 3Q-2017' (October 2017) <<https://www.lazard.com/media/450309/lazard-review-of-shareholder-activism-q3-2017-final.pdf>> accessed 1 February 2018. One might predict that the CEO turnover figures may be even higher when activist hedge funds secure board representation.

⁸ See Brian R Cheffins, 'Delaware and the Transformation of Corporate Governance' (2015) 40 Delaware Journal of Corporate Law 1, 61-69, and Bengt Holmström and Steven N Kaplan, 'Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s' (2001) Journal of Economic Perspectives 15(2) 121, 132. Other commentators have questioned whether defensive measures, rather than deterring bidders altogether, may have simply resulted in a change of tactics, where US acquirers are more likely to enter into negotiations with the target's board rather than make a hostile offer. See John Armour and David A Skeel Jr 'Who Writes the Rules for Hostile Takeovers, and Why? – The Peculiar Divergence of U.S. and U.K. Takeover Regulation' (2007) 95 Georgetown Law Journal 1727, 1741.

⁹ John Pound, 'The Rise of the Political Model of Corporate Governance and Corporate Control' (1993) 68 New York University Law Review 1003, Bernard S Black, 'Shareholder Passivity Reexamined' (1990) Michigan Law Review 520, Bernard S Black, 'Agents Watching Agents: The Promise of Institutional Investor Voice' (1992) 39 UCLA Law Review 811.

¹⁰ Stuart L Gillan and Laura T Starks, 'The Evolution of Shareholder Activism in the United States' (2007) 19 Journal of Applied Corporate Finance 55, 56-58.

with conflicts of interest as well as incentivisation and collective action problems,¹¹ which meant that their activism fell short of expectations and ultimately proved to be a disappointment.¹² The lack of an effective market for corporate control combined with the reticence of traditional institutional investors led to boards becoming insulated.¹³ Activist hedge funds stepped up to fill the void that was created.¹⁴

In recent years, activist hedge funds have secured board representation in an increasing number of US public companies, and to a lesser extent in UK public companies.¹⁵ This has created what I term an active *market for corporate quasi-control*. I define *quasi-control* as power that is greater than influence but that falls short of actual corporate control. I argue that quasi-control is most often manifested in the form of one or more board seats being held by activist hedge funds or their nominated non-affiliated representatives, which can often lead to the replacement of significant corporate managers, such as the CEO or CFO.

¹¹ One problem is ‘agency capitalism’, or the ‘separation of ownership from ownership’, namely that ownership structures involving agents holding shares for beneficial owners give rise to a double set of agency problems as the interests of money managers may differ from the interests of beneficial owners. See Ronald J Gilson and Jeffrey N Gordon, ‘The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights’ (2013) 113 Columbia Law Review 863, 865 and Leo E Strine Jr, ‘Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance’ (2007) 33 The Journal of Corporation Law 1, 6-7.

¹² Armour and Skeel, ‘Who Writes the Rules for Hostile Takeovers’ (n 8), 1790 and Edward B Rock ‘The Logic and (Uncertain) Significance of Institutional Shareholder Activism’ (1991) 79 Georgetown Law Journal 445, 453-463.

¹³ Lucian A Bebchuk, ‘The Myth of the Shareholder Franchise’ (2007) 93 Virginia Law Review 675, 681 and 714. Insulation has been argued to negatively affect firm value. See Lucian A Bebchuk and Alma Cohen, ‘The Costs of Entrenched Boards’ (2005) 78 Journal of Financial Economics 409.

¹⁴ The UK equities market in the 1990s and 2000s was more institutionally dominant than the US stock market and communication among institutional investors in the UK has traditionally been easier. See Bernard S Black and John C Coffee Jr, ‘Hail Britannia?: Institutional Investor Behavior Under Limited Regulation’ (1994) 92 Michigan Law Review 1997, 2002. Although there was less of a void for activist hedge funds to fill in the UK, and the close-knit financial community in the UK had the potential to foster greater institutional investor activism, UK institutions also remained relatively passive. See Brian R Cheffins, *Corporate Ownership and Control: British Business Transformed* (Oxford University Press 2008), 370-397.

¹⁵ See Part I Section (a) and n 50 below for statistics on activist board representation. For some examples of activist campaigns for board representation in US and UK companies, see Part II Section (b).

I argue that hedge fund minority board representation is a potential solution to the problem of shareholder-manager agency costs.¹⁶ Although hedge funds are routinely criticised for being short-term in focus and hostile towards incumbent management,¹⁷ it is open to debate whether short-term goals are in fact problematic or are necessarily inconsistent with long-term goals.¹⁸ However, even if short-termism is acknowledged as a potential problem, I argue that the increased prevalence of activist hedge funds seeking and securing board representation could be a positive, rather than negative, development. Hedge funds rarely control boards, so their power exists in the form of quasi-control. Their minority directors can usually only implement changes if they are able to convince other long-term institutional investors of their value and the wider board of directors of the soundness of their strategies.¹⁹ Activist representation on target boards can also signal a strengthened commitment to target companies that is accompanied by longer-term investment horizons and positive strategic and operational changes.²⁰ The nature of such minority board representation can therefore mitigate some of the typical criticisms directed at traditional hedge fund activism.

I further argue that widely criticised recent innovations in hedge fund activism such as ‘wolf pack activism’, where more than one hedge fund descends upon a

¹⁶ Shareholder-manager ‘agency costs’ are thought to arise when managers’ interests diverge from shareholder interests. See Michael C Jensen and William H Meckling, ‘Theory of the Firm: Management Behavior, Agency Costs, and Ownership Structure’ (1976) 3 *Journal of Financial Economics* 305, 308 for a discussion of managerial agency costs. See also John Armour, Henry Hansmann and Reinier Kraakman, ‘Agency Problems and Legal Strategies’ in Reinier Kraakman and others (eds), *The Anatomy of Corporate Law* (3rd ed, Oxford University Press 2017) 29-31.

¹⁷ See Part III Section (a) below for references to the short-termism literature.

¹⁸ Moore and Petrin note that stock market short-termism is not dissimilar to global warming in the sense that for every commentator who regards it as one of the most serious problems facing the corporate and financial world there is another commentator equally keen to deny that it is even a material problem at all. See Marc Moore and Martin Petrin, *Corporate Governance: Law Regulation and Theory* (Palgrave 2017), 119.

¹⁹ See Part IV Section (c) below for a discussion of the safeguards that can protect against hedge fund activism that may not be beneficial for the company.

²⁰ See Part IV Section (a) for a discussion of the potential longer-term perspective activist hedge funds may have when they seek and secure activist board representation.

company, and ‘golden leash’ compensation structures, which incentivise activist appointed directors to increase the share price of target companies, serve to promote the market for corporate quasi-control I have identified. Wolf packs increase the probability of activists successfully securing board representation and golden leash compensation structures help to facilitate a market for activist board members, where well-reputed directors are recruited to suitable board positions, improving the overall quality of activist strategy and potentially lengthening the time horizon of activist investments.²¹

Hedge fund activists have not only filled a void by creating what I identify as a market for corporate quasi-control. In addition, they have reincarnated the market for corporate control to some extent through M&A activism. They have also reinvigorated institutional investor activism by mobilising previously passive institutional investors. Hedge funds contribute to the market for corporate control most commonly by identifying potential takeover targets to be acquired by a third party bidder, but also by launching full proxy fights for control,²² and occasionally by making hostile bids themselves.²³ Institutional investors also play an increasingly important role as corporate governance intermediaries in activist campaigns. As activist hedge funds rely upon the support of other large shareholders in order to succeed in their campaigns,²⁴ institutional investors provide valuable support to activists and operate as an important safeguard when activist proposals may not be in the best interests of the company.²⁵

²¹ See Part II Section (c) for a discussion of wolf packs and Part IV Section (b) for a discussion of the golden leash compensation mechanism.

²² For a brief discussion of some recent proxy fights for board control initiated by hedge fund activists, see Part I Section (c) below. M&A activism is discussed briefly in Part I Section (a) below but is largely outside of the scope of this paper. The rise in M&A activism is discussed in Nicole M Boyson, Nickolay Gantchev and Anil Shivdasani, ‘Activism Mergers’ (2017) 126 *Journal of Financial Economics* 54.

²³ Marcel Kahan and Edward B Rock, ‘Hedge Funds in Corporate Governance and Corporate Control’ (2007) 155 *University of Pennsylvania Law Review* 1021, 1040.

²⁴ See Gilson and Gordon, ‘The Agency Costs of Agency Capitalism’ (n 11), 896-901.

²⁵ For a discussion of the changing role of institutional investors and the important function they play in hedge fund activism, see Part IV Section (c) below.

Regarding scope, I consider examples of corporate quasi-control in the Anglo-American system of corporate governance. As is the case with hedge fund activism more generally, the vast majority of activist board representation campaigns involve target companies in the United States. Nevertheless, UK companies have also been targeted on occasion. This article focuses on the US and the UK predominantly for their similarities rather than for their differences. Both common law jurisdictions have dispersed share ownership as opposed to concentrated ownership or family controlled stakes, and have similar systems of corporate governance.

The remainder of this article is structured as follows. Part I describes the rise in activist board representation as an evolving species of hedge fund activism. Section (a) considers the different types of hedge fund activism, and Sections (b) and (c) consider why hedge funds are increasingly seeking board seats in their activist campaigns and why minority board representation is generally favoured over attempts to gain full control over the board. Part II focuses on defining and discussing the market for corporate quasi-control. Section (a) discusses control and influence and introduces the market for corporate quasi-control. Section (b) considers case studies of activist board representation as examples of the market for corporate quasi-control, and Section (c) outlines the contribution that wolf pack activism has made to the market for corporate quasi-control. Part III offers a review of some of the traditional critiques of hedge fund activism, including: (a) short-termism and the impact of hedge fund activism on research and development; (b) the issues arising from hedge fund managers acting as company directors; and (c) notorious cases of so-called ‘bad activism’. Part IV advances some counter-arguments to address these common criticisms by focusing on the value that activist directors may have in corporate governance. Section (a) begins with a discussion of whether the trend of activist board representation could signal a

longer-term commitment on the part of activist hedge funds to the companies with which they engage. Section (b) discusses developments in activist director compensation and the contribution of the ‘golden leash’ compensation mechanism to the market for corporate quasi-control. Section (c) concludes with a discussion of potential safeguards that may help to prevent cases of ‘bad activism’, with a particular focus on the important role played by long-term institutional investors. Finally, Part V discusses what the future might hold for the market for corporate quasi-control. It begins in Section (a) by comparing the hedge fund activism debate to the hostile takeover debate of the 1980s. It also identifies some advantages hedge fund activism may have over hostile takeovers. Section (b) then discusses the future of activist board representation, particularly in the US. It contains an analysis of how activists and companies continue to evolve and adapt their strategies, and also briefly considers whether the US approach might ultimately converge to some extent with the UK approach of greater behind-the-scenes institutional investor dialogue. This also links to the final Section (c), which examines whether we might be witnessing a new culture of collaboration both between hedge fund activists and target companies, and also between hedge fund activists and institutional investors.

I. The Rise of Activist Board Representation

a. Types of Hedge Fund Activism

Activist hedge funds²⁶ now manage approximately \$176 billion in investor capital.²⁷

Hedge fund activism has grown significantly over the past decade, and according to one commentator, “no company can consider itself immune from hedge fund activism.

Indeed no company is too large, too popular or too successful”.²⁸ Targets in recent years have included very large companies, for example DuPont, Apple, Microsoft, eBay, Hess, Yahoo, and Proctor & Gamble.²⁹ Hedge fund activism is fundamentally different to other forms of institutional investor activism. Once stated to be “remarkably powerless”,³⁰ institutional investor activism often focuses on checklists of good corporate governance as opposed to company specific, targeted change. On the other hand, activist hedge funds proactively invest in target companies with the objective of implementing significant strategic changes at individual companies to improve corporate performance. Armour and Cheffins draw a distinction between *offensive* and

²⁶ Hedge funds were originally associated with the hedging of risk. See William W Bratton, ‘Hedge Funds and Governance Targets’ (2007) 95 Georgetown Law Journal 1375, 1382-1383 and Leo E Strine Jr, ‘Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System’ (2017) 126 The Yale Law Journal 1870, 1885-1886. Until recently, hedge funds were not registered. However, Section 404 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 required the SEC to establish reporting requirements for private funds, including hedge funds. The SEC established reporting requirements using Form PF. See Frank Partnoy, ‘U.S. Hedge Fund Activism’ in Randall S Thomas and Jennifer G Hill (eds), *Research Handbook on Shareholder Power* (Elgar 2015) 104.

²⁷ Assets under management of primary focus funds globally in 2016. See Activist Insight, ‘Activist Investing: an annual review of trends in shareholder activism’ (2017 report), 8, <<https://www.activistinsight.com/amp/issues/TheActivistInvestingAnnualReview2017.pdf>> accessed 1 February 2018.

²⁸ Martin Lipton, ‘Dealing with Activist Hedge Funds’ (*Harvard Law School Forum on Corporate Governance and Financial Regulation*, 2 June 2015) <<https://corpgov.law.harvard.edu/2015/06/02/dealing-with-activist-hedge-funds-4/>> accessed 1 February 2018.

²⁹ See Part IV Section (a) for a discussion of Triun Partners’ activist campaign targeting P&G.

³⁰ Michael C Jensen, ‘Eclipse of the Public Corporation’ (1989) 29 Harvard Business Review 61, 66.

defensive shareholder activism,³¹ with hedge funds representing the archetypal *offensive* shareholder activist. Hedge fund activism takes place *ex ante* rather than *ex post*. Hedge funds identify targets and purposefully invest in them to pursue an activist agenda, whereas other institutional investors tend to be reactionary and will engage in activism only to protect existing holdings. Activism can be public, as is often the case in the US, or it can take place behind closed doors, which is more common in the UK. It can also involve litigation against present or former managers.³²

Hedge fund activism can take many forms, which I categorise as balance sheet activism, operational or strategic activism, governance activism, M&A activism and finally activist board representation, which is the focus of this paper.³³

The most heavily criticised type of hedge fund activism is *balance sheet activism*, as it is often regarded as short-term in focus, much like leveraged buyouts and the activities of controversial corporate raiders were viewed in the 1980s.³⁴ Such activism generally involves a direct intervention on financial matters and seeks to undercut the decision making authority of the board, for example by pressuring the target company to increase leverage or return cash to shareholders via an increase in dividends or a share buyback.³⁵

Operational or strategic activism is another common form of hedge fund activism. Operational activism can involve any business or strategic decisions, and often

³¹ Brian R Cheffins and John Armour, 'The Past, Present and Future of Shareholder Activism by Hedge Funds' (2011) 37 Journal of Corporation Law 51, 56.

³² Kahan and Rock, 'Hedge Funds in Corporate Governance' (n 23), 1029.

³³ See Alon Brav, Wei Jiang, Frank Partnoy and Randall Thomas, 'Hedge Fund Activism, Corporate Governance, and Firm Performance' (2008) LXIII The Journal of Finance 1729, 1741 and 1744 for a discussion of some activist hedge fund objectives.

³⁴ See Part III Section (a) below for a discussion of the short-termism literature.

³⁵ Some prominent recent examples of balance sheet activism are Greenlight Capital's campaign to persuade Apple to return some of its \$137 billion cash to shareholders and ValueAct Capital's campaign at Microsoft, which included returning cash to shareholders.

includes advocating for efficiency measures, cost cutting, and restructuring.³⁶ This type of activism is frequently accompanied by a campaign for board seats to ensure that the activists can effectively implement the desired changes.

Hedge funds also engage in *governance activism*. This type of activism has similar objectives to those pursued by other institutional investors such as pension funds and mutual funds. In the US, governance activism often involves campaigns to remove staggered boards and redeem poison pills.³⁷ In both the UK and the US, the focus is generally on issues such as board independence and executive compensation. Although governance issues are frequently included in activist hedge fund agendas, this is not normally their core focus and could be viewed as a tactical means of securing much needed support from institutional investors for other aspects of the hedge fund's campaign.³⁸ It is very doubtful that a hedge fund activist would invest in a company solely to push for procedural corporate governance changes, as even if the target company implemented such changes, any increase in value would likely be insufficient to incentivise hedge fund activists or make their campaigns economically viable.

Activist hedge funds also pursue *M&A activism*.³⁹ Hedge funds can advocate for

³⁶ Examples of operational activism include Elliott's campaigns against Hess in 2013 and again in 2017-2018 and Third Point's attack on The Dow Chemical Company.

³⁷ Hedge fund activists and other investors have been effective in securing the removal of staggered boards and poison pills. In 2002, 60% of S&P 500 companies had staggered boards in place, which had dropped to 18% by 2012. In 2002, 62% of S&P 1500 companies had poison pills in place, compared with 12% in 2012. See Guhan Subramanian, 'Delaware's Choice' (2014) 39 *Delaware Journal of Corporate Law* 1, 11. It is important to note, however, that companies can enact a poison pill following a threat of a takeover or of activism.

³⁸ Bratton, 'Hedge Funds and Governance Targets' (n 26), 1397, argues that hedge fund activism is about value so governance takes second place on the agenda. Bratton also argues that governance activism may play a tactical role to increase the activist's credibility with institutional investors. Similar arguments have been advanced regarding hedge funds' recent foray into impact investing and focus on environmental, social and governance activism. See, for example, Charles Nathan, 'Activists and Socially Responsible Investing' (*Harvard Law School Forum on Corporate Governance and Financial Regulation*, 31 January 2018). <<https://corpgov.law.harvard.edu/2018/01/31/activists-and-socially-responsible-investing/>> accessed 12 February 2018, which argues that the principal purpose of Jana Partners' new impact investing fund is to create a 'halo effect' that will advance Jana's traditional activist investing model.

³⁹ See Robin Greenwood and Michael Schor, 'Investor Activism and Takeovers' (2009) 92 *Journal of Financial Economics* 362, arguing that activism only leads to long-term value when target companies

a sale to, or merger of the company with, a third party,⁴⁰ oppose a merger with or acquisition of a third party,⁴¹ object to the terms of a takeover or merger,⁴² propose acquiring a third party company and propose spin-offs or divestments of divisions.⁴³ Rarely, activist hedge funds have also played a controversial function by collaborating with bidders to attempt hostile takeovers as a bidder/activist combination, as in the notorious attempted acquisition of Allergan by Pershing Square and Valeant Pharmaceuticals.⁴⁴ Occasionally, hedge funds will bet against companies and short their stock, as seen in Pershing Square's attack on Herbalife.⁴⁵ The increasing prevalence of

are subsequently acquired. See also Boyson, Gantchev and Shivdasani, 'Activism Mergers' (n 22), arguing that shareholder value creation from hedge fund activism occurs primarily by influencing takeover outcomes for targeted firms and noting that activist interventions substantially increase the probability of a takeover offer.

⁴⁰ In recent years, there has been a steady increase in activist-driven deals, one prominent example being Jana Partners' investment in Whole Foods Market Inc in 2017. Jana sold its entire 8.2% Whole Foods stake (at a 40% profit) after Whole Foods agreed to Amazon.com Inc's \$13.7 billion acquisition offer. See Michael Flaherty, 'Activist hedge funds pull hard on the M&A lever' *Reuters* (New York, 25 July 2017), <<https://www.reuters.com/article/us-usa-hedgefunds-m-a/activist-hedge-funds-pull-hard-on-the-ma-lever-idUSKBN1AA0CD>> accessed 1 February 2018 and Stephen Foley and Lindsay Whipp, 'Activist Jana builds near 9% stake in Whole Foods' *Financial Times* (Chicago, 10 April 2017), <<https://www.ft.com/content/537ebd8e-1e21-11e7-a454-ab04428977f9>> accessed 1 February 2018.

⁴¹ One recent example was Starboard Value's objection to Yahoo undertaking acquisitions (with the exception of an AOL acquisition). See Michael J De La Merced, 'Activist Hedge Fund Again Warns Yahoo Against Making a Big Acquisition' *The New York Times* (New York, 8 January 2015) <<https://dealbook.nytimes.com/2015/01/08/activist-hedge-fund-again-warns-yahoo-against-striking-a-big-acquisition/>> accessed 12 February 2018. Another example is Carl Icahn's recent objection to Xerox's proposed merger with a Fujifilm joint venture. As Xerox's largest shareholder, Icahn believed that the deal "dramatically undervalues Xerox and disproportionately favours Fuji". See Mamta Badkar, 'Icahn urges Xerox shareholders to vote against Fujifilm deal' (New York, 12 February 2018) <<https://www.ft.com/content/6dc8cc60-1002-11e8-940e-08320fc2a277>> accessed 12 February 2018.

⁴² Activist hedge funds can object to merger terms in the US through appraisal rights litigation, whereby shareholders who object to a cash offer for their shares have the right to dissent and seek a higher price through litigation. There is some evidence that appraisal rights litigation may be on the rise. See David A Katz, 'Shareholder Activism in the M&A Context' (*Harvard Law School Forum on Corporate Governance and Financial Regulation*, 27 March 2014), <<https://corpgov.law.harvard.edu/2014/03/27/shareholder-activism-in-the-ma-context/>> accessed 1 February 2018.

⁴³ For example, Elliott Management wanted oil company Hess to carry out a significant restructuring program, including a spin-off of US shale assets. See, 'Elliott Management's Perspective on Hess' SEC EDGAR database, <https://www.sec.gov/Archives/edgar/data/4447/000110465913005512/a13-3887_2ex1.pdf> accessed 1 February 2018.

⁴⁴ See Part III Section (c) for a full discussion of this case.

⁴⁵ Bill Ackman of Pershing Square proclaimed Herbalife to be an illegal pyramid scheme rather than a legal multilevel marketing company. See Joe Nocera, 'For Better and Worse, Ackman's Still Betting Against Herbalife' *Bloomberg* (New York, 1 March 2017) <<https://www.bloomberg.com/view/articles/2017-03-01/for-better-and-worse-ackman-s-still-betting-against-herbalife>> accessed 12 February 2018.

M&A activism raises the question of whether activist hedge funds could generate a revival of the hostile takeover, especially when developed in parallel with the efforts of other institutional investors to eliminate or reduce the impact of various takeover defences.⁴⁶

In recent years, activist hedge funds have increasingly sought to secure minority representation on the boards of target companies. *Activist board representation* is now the most common form of hedge fund activism,⁴⁷ with recent data suggesting that board representation is an objective of around 50% of activist campaigns.⁴⁸ Activist campaigns for board representation also have increasingly high success rates, with activists winning 73% of battles for board seats in 2014, compared with 52% in 2012.⁴⁹ The number of board seats won by US and European hedge fund activists globally rose to a record high of 145 board seats in 2016, compared to 70 seats in 2013, and the number of companies targeted increased from 46 in 2013 to 79 in 2016.⁵⁰ Activist board

⁴⁶ In the UK, activist hedge fund Elliott has exerted pressure on FTSE-100 listed GKN to engage in takeover discussions with Melrose Industries, after GKN rejected Melrose's £7.4 billion hostile offer. This is the largest hostile takeover bid since Kraft's bid for Cadbury in 2009.

⁴⁷ Sullivan & Cromwell, '2016 US Shareholder Activism Review and Analysis', 15 <<https://www.sullcrom.com/2016-us-shareholder-activism-review-and-analysis-activists-face-headwinds-in-2016>> accessed 12 February 2018.

⁴⁸ Lazard Review of Shareholder Activism in 2016, 2 outlined that 50% of campaigns in 2016 involved the objective of board changes. Based on *Activist Insight*, *FactSet* data and public filings. Data for activist campaigns conducted by US activists targeting global companies or non-US activists targeting US companies with market capitalisations greater than \$500 million at the time of the campaign announcement. For older data, see also April Klein and Emanuel Zur, 'Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors' (2009) LXIV *The Journal of Finance* 187, 215. Klein and Zur studied hedge fund campaigns between 2003 and 2005 and found that 40% of the hedge fund campaigns involve an actual (12%) or threatened (28%) proxy contest. Brav and others, 'Hedge Fund Activism' (n 33), 1743 also analysed data to 2006 to find that activist hedge funds launched a proxy fight to gain board representation in 13.2% of activist events.

⁴⁹ David Benoit and Kirsten Grant, 'Activists' Secret Ally: Big Mutual Funds—Large investors quietly back campaigns to force changes at US companies' *The Wall Street Journal* (New York, 10 August 2015) <<https://www.wsj.com/articles/activist-investors-secret-ally-big-mutual-funds-1439173910>> accessed 12 February 2018, cited in John C Coffee Jr and Darius Palia, 'The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance' 41 *Journal of Corporation Law* (2016) 41(3) 545, 556.

⁵⁰ Lazard's Shareholder Advisory Group, '2017 Activism Year in Review' (January 2018), 5. Based on *Activist Insight*, *FactSet* data and public filings. Data for activist campaigns conducted by US and European activists at companies globally with market capitalisations greater than \$500 million at the time of the campaign announcement. There was a decline in the number of board seats won in 2017 (to 100 board seats). There was a decline in the number of companies targeted in 2017 (to 50 companies).

representation can be achieved through an actual proxy fight or a negotiated settlement, which is often catalysed by a threatened proxy fight. 88% of the board seats won in 2016 were achieved through settlement agreements rather than proxy contests, compared to 70% in 2013 and 66% in 2014.⁵¹

Non-affiliated directors play an important role in board related activism, as opposed to hedge funds simply securing seats for their own representatives. Here, a novel development known as the ‘golden leash’ contributes to a market for activist board directors, where activist hedge funds source and recruit expert directors to serve on boards.

b. Why Activist Board Representation?

Proxy contests are not a new concept. Beginning in the 1950s, there were various high profile battles for the control of companies in the United States.⁵² However, hedge fund activism did not become a fundamental part of US corporate governance until the 2000s⁵³ and activist board representation is an even more recent phenomenon.

There are various potential explanations for the recent rise in activist board representation campaigns. Firstly, board representation could simply be viewed by activist hedge funds as a means to an end or as an intermediary step to help them to achieve other goals. Activist hedge funds ultimately aim to increase the value of their shares, usually through operational or strategic activism, M&A activism or balance

⁵¹ Lazard Review 2017 (n 50), 5.

⁵² See Armour and Skeel, ‘Who Writes the Rules for Hostile Takeovers’ (n 8), 1752 for a discussion of the Young proxy contest for the control of the New York Central Railroad in 1954. See also John Armour and Brian Cheffins, ‘Stock Market Prices and the Market for Corporate Control’ (2016) University of Illinois Law Review 761, 781, noting that between 1900 and 1965 the authors identified 398 proxy contests where the protagonists were seeking to obtain control of the board.

⁵³ Cheffins and Armour, ‘Past, Present and Future of Shareholder Activism’ (n 31), 102. For a history of the direct antecedents to activist hedge funds see 75-81.

sheet activism.⁵⁴ Although hedge funds can try to pursue these other types of activism without having the benefit of one or more board seats, having access to the board can expedite progress towards their desired goals and render their campaigns more likely to succeed.

A related benefit of activist board representation is access to confidential information.⁵⁵ Coffee goes so far as to argue that hedge fund activism, and in particular wolf pack activism, may be fuelled by subsidies caused by access to material, non-public information.⁵⁶ Once hedge funds secure board representation, they have access to confidential company documents and data that they would not otherwise be able to access. Activists are also sometimes given board observer status in settlement agreements, which shows that access to the board and the associated information that status provides is valuable to hedge fund activists even if formal board representation is not secured.

Seeking minority board representation could also be a less controversial and less adversarial means of promoting positive change at target companies, especially as negotiated settlements become more commonplace. Proxy fights, even for one or two

⁵⁴ Similarly, it has been noted that settlement agreements bring about major changes in board composition as opposed to directly providing the operational changes activists seek. But settlements are followed by such changes, including increases in CEO turnover, increased payouts to shareholders, and higher likelihood of a sale or going-private transaction. See Bebchuk and others, 'Dancing with Activists' (n 7), 33. See also John C Coffee Jr, Robert J Jackson Jr, Joshua R Mitts and Robert E Bishop, 'Activist Directors and Agency Costs: What Happens When an Activist Director Goes on the Board?' Columbia Business School Research Paper No 18-15, 11 <<https://ssrn.com/abstract=3100995>> accessed 12 February 2018, which notes that directors, as fiduciaries, cannot contract away their discretion.

⁵⁵ Another way that activists can obtain information is by a "220 demand" which refers to the right of a shareholder, under §220 of the Delaware General Corporation Law, to examine certain corporate books and records for any proper purpose. See Sujeet Indap, 'Shareholders win a new legal tool to challenge M&A deals' *Financial Times* (New York, 12 February 2018) <<https://www.ft.com/content/bb2ed60a-0d39-11e8-839d-41ca06376bf2>> accessed 12 February 2018.

⁵⁶ Coffee and others' analysis of 475 private settlement agreements, extending from 1 January 2000 to 31 December 2015 revealed that once an activist-nominated director joins a target board pursuant to a settlement agreement, an abrupt pattern of "information leakage" follows, with the result that the target company's share price begins to anticipate future public disclosures. See Coffee and others, 'Activist Directors and Agency Costs' (n 54), 5 and 7.

board seats, often begin to resemble political campaigns, so can be aggressively fought and vigorously defended by the companies that are targeted.⁵⁷ On the other hand, settlements between an activist and a target company for one or two board seats are often quickly agreed upon.⁵⁸ Management of the target company may wish to avoid a costly proxy contest and the associated disruption and expense caused by a bitter fight.⁵⁹ Taking a cynical view, one might also argue that management is entrenched and seeks to protect their own positions by settling with hedge fund activists. Hedge fund activists also have incentives to reach settlements on board seats as such representation likely leads to expedited progress in achieving their aims, access to valuable information and reduced expense.

Finally, activist board representation can signal a longer-term commitment on the part of hedge fund activists so often mitigates some of the criticisms associated with hedge fund activism, such as short-termism. Hedge funds need the support of long-term investors in order to succeed in their campaigns,⁶⁰ so board representation could be a way of demonstrating a stronger commitment to the long-term success of target companies.

⁵⁷ A recent example of a proxy fight that resembled a political campaign is Trian's fight for a board seat for Nelson Peltz at Procter & Gamble.

⁵⁸ Whether expedient settlements between activist hedge funds and target companies for activist board representation are a positive compromise or serve to disenfranchise long-term shareholders is a matter of debate. See Part IV Section (c) below for a discussion of the issues.

⁵⁹ See Lucian A Bebchuk, Alon Brav and Wei Jiang, 'The Long-Term Effects of Hedge Fund Activism' (2015) 115 Columbia Law Review 1085, 1141, noting that the adversarial tactics on the part of hedge fund activists could be viewed by target companies as especially costly and disruptive.

⁶⁰ Empirical evidence suggests that activists are likely to target firms with significant institutional investor ownership. See Brav and others, 'Hedge Fund Activism' (n 33), 1750, noting that activist targets have on average approximately 45% institutional ownership, and Nickolay Gantchev, 'The Costs of Shareholder Activism: Evidence from a Sequential Decision Model' (2013) 107 Journal of Financial Economics 610, 622-623, noting that "targets have significantly higher institutional ownership, which is a critical determinant of campaign success in the more confrontational stages of activism". Both cited in Gilson and Gordon, 'The Agency Costs of Agency Capitalism' (n 11), 899.

c. The Focus on Minority Board Seats

Hedge funds have occasionally attempted to overthrow entire boards, for example in the case of Yahoo⁶¹ and in the recent case of Newell.⁶² They have succeeded on occasion, mostly notably in Darden Restaurants.⁶³ However, more commonly the activist hedge fund will seek minority board representation. Securing minority board representation (especially by way of negotiated settlement) is a much cheaper alternative to engaging in a proxy contest or pursuing a hostile takeover. It also makes sense from the perspective of the activist hedge funds as such funds invest across a number of different companies as opposed to focusing their efforts entirely on one or two targets.

Further, it is much more difficult to secure institutional investor support for full slates of director candidates, as opposed to one or two minority seats. Institutional investors have been reported to make ‘requests for activism’ and provide support to hedge fund activists who then seek minority board representation,⁶⁴ but would only rarely support an entire slate of new director candidates. Proxy advisory companies, such as Institutional Shareholder Services (ISS) and Glass Lewis, are also much more

⁶¹ In 2016, activist hedge fund Starboard Value launched a proxy fight to replace the entire board of Yahoo. See Michael Flaherty and Supantha Mukherjee, ‘Starboard launches proxy fight to remove entire Yahoo board’ *Reuters* (New York, 29 March 2016) <<http://uk.reuters.com/article/us-yahoo-starboard-proxy-idUKKCN0WQ0D7>> accessed 12 February 2018.

⁶² In February 2018, activist hedge fund Starboard Value (a 4% shareholder) nominated a full slate of candidates to Newell Brands Inc’s board, including two directors who resigned from the board in January 2018. See Nivedita Balu, Vibhuti Sharma and Harry Brumpton, ‘Starboard nominates candidates to replace Newell’s board’ *Reuters* (New York, 12 February 2018) <<https://www.reuters.com/article/us-newell-brands-starboard/starboard-nominates-candidates-to-replace-newells-board-idUSKBN1FW1G0>> accessed 12 February 2018.

⁶³ In 2014, Darden shareholders voted to replace its entire board with a slate of 12 directors nominated by hedge fund Starboard Value. The hedge fund was Darden’s second largest shareholder, with a stake of 8.8%. See Julie Jargon, Joann S Lublin and David Benoit, ‘Starboard Succeeds in Replacing Entire Darden Board’ *The Wall Street Journal* (New York, 10 October 2014) <<https://www.wsj.com/articles/darden-shareholders-elect-all-12-starboard-nominated-directors-1412949459>> accessed 12 February 2018.

⁶⁴ See Owen Walker, ‘Barbarians in the Boardroom: Activist Investors and the Battle for Control of the World’s Most Powerful Companies’ (Pearson 2016), 49 (noting that several investors in Darden contacted Starboard Value to persuade the hedge fund to target the company), 70 (noting that investors in Yahoo had urged Carl Icahn to launch a campaign) and 147-148 (noting that some of the largest investors in Microsoft encouraged ValueAct Partners to seek a board seat).

likely to support a campaign for minority board representation, as it is a governance red flag to allow one investor to select the entire board of directors of a company, especially since the interests of a hedge fund investor may not necessarily coincide with the interests of other shareholders. Minority board seats can also be secured via a settlement agreement with the target company, whereas winning representation for a significant number of directors will inevitably require a proxy contest.

Finally, the trend of minority activist board representation is likely symptomatic of a more general culture of collaboration and a less adversarial mindset in the hedge fund activism sphere. Although there are certainly still many cases where battles (even for one or two board seats) are fought in a public and aggressive manner, many hedge fund ‘attacks’ could now be more appropriately described as hedge fund ‘engagement’, where boards, hedge funds and other investors work together in a more collaborative and constructive manner.⁶⁵

II. The Market for Corporate Quasi-Control

a. Control, Influence and Quasi-Control

Shareholder activism is often defined as dissatisfied investors attempting to initiate change in a company *without a change in control*.⁶⁶ However, hedge funds occasionally do execute a change of control themselves or act as a broker to put the company in play for a takeover. Cheffins and Armour distinguish between control and influence, also noting that “conceptually seeking influence and seeking control constitute points on a continuum rather than being fully distinct corporate governance phenomena”.⁶⁷ They

⁶⁵ For a more detailed discussion on a potential new culture of collaboration, see Part V Section (c).

⁶⁶ Gillan and Starks, ‘Evolution of Shareholder Activism’ (n 10), 55.

⁶⁷ Cheffins and Armour, ‘Past, Present and Future of Shareholder Activism’ (n 31), 59.

outline that offensive shareholder activism underpins a market for corporate influence which involves “attempts to use a sizeable minority stake in a public company as a platform to press for change”. On the other hand, the market for corporate control⁶⁸ involves bids to obtain full voting control.⁶⁹

I argue that a third distinct category is analytically helpful, especially as hedge funds rarely seek actual control⁷⁰ but often exert power significantly beyond the influence that might ordinarily be exerted by other institutional investors. Hedge funds typically exercise what I define as *quasi-control* - power that extends beyond influence but that falls short of actual legal control.⁷¹ The concept of quasi-control is consistent with Cheffins and Armour’s “continuum” concept and marks a new, and significant, point on that continuum.

What I describe as the *market for corporate quasi-control* has become increasingly prominent in recent years. Gaining board representation can be described as *quasi-control* rather than *influence* as even winning one seat on a company board has enabled activists to make sweeping changes to companies, including fundamental changes to corporate strategy and dismissal of the CEO or CFO. Despite lacking actual control, the activist agenda still has considerable power, as board representation allows the activist to be heard in the boardroom. Quests for board seats rarely involve seeking

⁶⁸ Henry G Manne, ‘Mergers and the Market for Corporate Control’ (1965) 73 Journal of Political Economy 110. Manne advocated that control of companies was a valuable asset and that an active market for corporate control exists.

⁶⁹ Cheffins and Armour, ‘Past, Present and Future of Shareholder Activism’ (n 31), 58.

⁷⁰ Brav and others, ‘Hedge Fund Activism’ (n 33), 1729 state that “hedge funds seldom seek control and in most cases are nonconfrontational” (based on data from 2001 to 2006). See also William W Bratton, ‘Hedge Fund Activism, Poison Pills, and the Jurisprudence of Threat’ in William Savitt, Steven Davidoff Solomon and Randall Thomas (eds), *The Corporate Contract in Changing Times: Is the Law Keeping Up?* (University of Chicago Press, 2017).
<http://scholarship.law.upenn.edu/faculty_scholarship/1667/>

⁷¹ The Delaware courts have also referred to power that extends beyond influence in terms of “creeping control”, “negative control” or “disproportionate influence”. See Part II Section (b) below for a full discussion of these concepts.

actual control and even when proxy fights are launched, more often than not these involve short slates, to gain minority board representation, rather than full slates. Activist directors will constitute a minority voice in the boardroom and the support of the rest of the board is vital for them to be able to implement any changes. Activist appointed directors, whether they are unaffiliated with the hedge fund or are the hedge fund managers themselves, also still have fiduciary duties to the company, so cannot blindly pursue the activist agenda to the detriment of the long-term success of the company.

The equity stakes that hedge fund activists take in their targets also tend not to come anywhere close to voting control, the average holding being around 8%.⁷² Yet, gaining board representation can allow activist hedge funds that hold a relatively low percentage of shares⁷³ to have a significant impact on the companies with which they engage.

b. Quasi-Control Case Studies

A prime US example, which illustrates the phenomenon of corporate quasi-control, is a case involving Sotheby's, the oldest publicly traded company on the New York Stock Exchange. Sotheby's, the auctioneer of fine art and jewellery, became the target of a 'wolf pack' of three hedge fund activists (Marcato Capital Partners, Third Point Partners and Trian Fund Management) in 2013.⁷⁴ The involvement of the three hedge fund activists ultimately led to a poison pill, shareholder litigation, a proxy contest and

⁷² Based on a dataset of activist interventions from 2008 to 2014. See CNV Krishnan, Frank Partnoy and Randall S Thomas, 'The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Experience' (2016) 40 *Journal of Corporate Finance* 296, 297.

⁷³ Activist hedge funds have secured board representation in cases where they hold a relatively low percentage of the target company's shares. For example, in 2013 ValueAct Capital gained a seat on Microsoft's board with less than 1% of company's shares and in 2017 Trian Partners gained a seat on P&G's board with around 1.5% of the company's shares.

⁷⁴ See Part II Section (c) for a discussion of wolf pack activism.

finally a negotiated settlement.

In response to the activists' demands, Sotheby's proceeded to make various corporate changes,⁷⁵ and also implemented defensive mechanisms by adopting a two-tier shareholder rights plan (poison pill)⁷⁶ that was directly targeted at the hedge fund activists. The terms of the poison pill were doubly discriminatory⁷⁷ as it would be triggered at a 10% threshold for those stockholders who file a Schedule 13D but a 20% threshold for those stockholders who file a Schedule 13G.⁷⁸

In 2014, Third Point revealed that it would take Sotheby's to court over the company's poison pill. By the time of the litigation, Third Point was Sotheby's largest

⁷⁵ In response to the activists' initial involvement, Sotheby's made various corporate changes, including a review of its business strategy, a decision to sell its Manhattan headquarters, and an announcement that the CFO would leave the company at the end of 2013. However, this did not appease the activists, with Third Point stating that Sotheby's was "an old master painting in desperate need of restoration" and persisting in its campaign for the CEO, William Ruprecht, to be fired. Further measures were instituted by Sotheby's, including a \$300 million special dividend and a \$150 million share buyback. See Elizabeth Paton, 'Third Point urges Sotheby's chief William Ruprecht to quit' *Financial Times* (New York, 2 October 2013) <<https://www.ft.com/content/89a3a788-2b74-11e3-a1b7-00144feab7de>>, Philip Boroff and Katya Kazakina, 'Goldman's McClymont Named Sotheby's CFO; Sheridan Leaving' *Bloomberg* (New York, 23 September 2013) <<https://www.bloomberg.com/news/articles/2013-09-23/goldman-s-mcclymont-named-sotheby-s-cfo-sheridan-leaving>> and Sara Germano, 'Sotheby's to Pay Special Dividend' *The Wall Street Journal* (New York, 29 January 2014) <<https://www.wsj.com/articles/SB10001424052702303519404579350483586334394>> all accessed 12 February 2018.

⁷⁶ A shareholder rights plan, or "poison pill" is a hostile takeover defence designed to dilute a bidder's stake if the bidder acquires more than a specified percentage of the target company's shares (usually 10% or 15%). If triggered, a poison pill operates by inviting the target company's other shareholders (excluding the hostile bidder) to purchase additional shares at a discount. The poison pill was invented by Martin Lipton of the law firm Wachtell, Lipton, Rosen and Katz in the early 1980s. In *Moran v Household International Inc* 500 A 2d 1346 (Del 1985), the Delaware Supreme Court approved the adoption of a poison pill in anticipation of a possible hostile bid and stated that a target board's decision not to redeem a pill in the face of an actual offer would be treated as a defensive tactic reviewable under the *Unocal* standard. The Takeover Code in the UK prohibits poison pills.

⁷⁷ The hallmark of the poison pill is discriminatory dilution. See George S Geis, 'Internal Poison Pills' (2009) 84(5) *New York University Law Review* 1169, 1201.

⁷⁸ *Third Point LLC v William F Ruprecht et al, and Sotheby's* CA No 9469-VCP (Del Ch May 2, 2014), 1. Schedule 13D and Schedule 13G forms are beneficial owner disclosure statements that must be filed with the SEC when a person or group acquires more than 5% of any class of a company's shares. A Schedule 13G can be filed if the stake is less than 20% and the investor did not acquire the shares with the purpose or effect of changing or influencing the control of the issuer. If the stake increases above 20% or the holder has an intention to change or influence control, a Schedule 13D must be filed. As hedge funds file 13Ds, this limited the funds' individual stakes in Sotheby's to 10%. Although a poison pill does not prevent the hedge funds from launching a proxy contest (and indeed Third Point did launch a proxy contest, regardless of the poison pill), an increased stake makes it easier for a hedge fund activist to succeed in a proxy battle.

shareholder, beneficially owning approximately 9.6% of Sotheby's common stock.⁷⁹ However, an expert witness for Sotheby's estimated that 32.86% of Sotheby's stock was held by hedge funds.⁸⁰ The Delaware Court of Chancery used the standard established in *Unocal*⁸¹ to deny Third Point's application for a preliminary injunction. In its decision, the court considered concepts of "negative control",⁸² "creeping control,"⁸³ and "disproportionate control and influence".⁸⁴ A determining factor for the court in the case was that in approving the poison pill, the board had referred to the risk of "creeping control" by the "wolf pack" of hedge funds. Vice Chancellor Parsons held that "I cannot conclude that there is a reasonable probability that the Board did not make an objectively reasonable determination that Third Point posed a threat of forming a control block for Sotheby's with other hedge funds without paying a control premium"⁸⁵ and that the Board "had an objectively reasonable belief that Third Point

⁷⁹ *Third Point* (n 78), 3.

⁸⁰ Coffee and Palia, 'The Wolf at the Door' (n 49), 567; John C Coffee Jr, 'Hedge Fund Activism: New Myths and Old Realities', (*Columbia Law School's Blog on Corporations and the Capital Markets*, 19 May 2014) <<http://clsbluesky.law.columbia.edu/2014/05/19/hedge-fund-activism-new-myths-and-old-realities/>> accessed 1 February 2018.

⁸¹ In *Unocal Corp v Mesa Petroleum Co* 493 A 2d 946 (Del 1985), the Delaware Supreme Court announced a proportionality standard of review for defensive tactics, holding that the target board has the power to take defensive measures in response to a hostile bid that poses a threat to corporate policy and shareholder interests provided that the measures taken are a reasonable response to the threat.

⁸² Vice Chancellor Parsons noted that "I am persuaded that Sotheby's has made a sufficient showing as to at least one objectively reasonable and legally cognizable threat: negative control." See *Third Point* (n 78), 50. He also noted that "In this case...there appears to be an objectively reasonable basis to believe that Third Point could exercise effective negative control over the Company. If Third Point was given the waiver it requested and achieved 20% ownership it would, by far, be Sotheby's largest single stockholder. That fact, combined with the aggressive and domineering manner in which the evidence suggests Loeb has conducted himself in relation to Sotheby's provides an adequate basis for legitimate concern that Third Point would be able to exercise influence sufficient to control certain important corporate actions, such as executive recruitment, despite a lack of actual control or an explicit veto power." See *Third Point* (n 78), 51-52.

⁸³ The relevant inquiry was noted to be whether "the adoption of the Rights Plan was a reasonable and proportionate response to that threat of creeping control". See *Third Point* (n 78), 50.

⁸⁴ Vice Chancellor Parsons noted that "Sotheby's may have had legitimate real world concerns that enabling individuals or entities, such as Loeb and Third Point, to obtain 20% as opposed to 10% ownership interests in the Company could effectively allow those persons to exercise disproportionate control and influence over major corporate decisions, even if they do not have an explicit veto power." See *Third Point* (n 78), 51.

⁸⁵ *Third Point* (n 78), 40.

continued to pose a “creeping control” risk to the Company, either individually or as part of a “wolf pack.””⁸⁶

The court also described the phenomena of “negative control” that could threaten corporate policy and effectiveness⁸⁷ and “disproportionate control and influence”.⁸⁸ Here, it is important to note that Third Point did not have an ownership interest resembling actual control, as it was a 9.6% shareholder of Sotheby’s stock. However, the court held that if Third Point were to achieve 20% ownership, there was an “adequate basis for legitimate concern that Third Point would be able to exercise influence sufficient to control certain important corporate actions, such as executive recruitment, despite a lack of actual control or an explicit veto power.”⁸⁹ Executive recruitment falls within the remit of the board, as opposed to being subject to a shareholder vote,⁹⁰ so this may have been a reference to Sotheby’s quest for board representation, especially as hedge fund manager Dan Loeb’s “aggressive and domineering manner”⁹¹ was also highlighted.

The court decision was issued on 2 May 2014 and Sotheby’s annual meeting was due to take place on 6 May 2014. On 4 May 2014, Third Point and Sotheby’s reached a settlement whereby Sotheby’s agreed to expand the board to add the three board nominees proposed by Third Point to Sotheby’s now 15-person board,⁹² and to

⁸⁶ *Third Point* (n 78), 50.

⁸⁷ *Third Point* (n 78), 53.

⁸⁸ *Third Point* (n 78), 51.

⁸⁹ *Third Point* (n 78), 51-52.

⁹⁰ Marcel Kahan and Edward B Rock, ‘Anti-Activist Poison Pills’ (2017) New York University School of Law, Law & Economics Research Paper Series Working Paper No 17-08, 21
<<https://ssrn.com/abstract=2928883>> accessed 12 February 2018.

⁹¹ *Third Point* (n 78), 51.

⁹² The expansion of boards to accommodate activist directors is an interesting phenomenon given that the size of US boards has been shrinking since the 1980s. See Jeffrey N Gordon, ‘The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices’ (2007) 59 *Stanford Law Review* 1465, for a discussion of the dramatic shifts in the composition of large public company boards between 1950 and 2005.

terminate the poison pill.⁹³ Third Point agreed to limit its ownership of Sotheby's stock to 15%. In November 2014, Sotheby's CEO stood down.⁹⁴

Third Point's involvement in Sotheby's exemplifies what I characterise as quasi-control, as opposed to influence or actual control. Third Point could not exercise control over the board. It did plan to engage in a proxy battle, but this was only for three board seats, and the hedge fund had less than a 10% interest in the company. Yet, Third Point's impact on Sotheby's extended well beyond influence.

Quasi-control in the form of board representation has also been sought by hedge funds in UK cases of activism. One example is Elliott's investment in Alliance Trust. Elliott Advisors (the UK arm of New York hedge fund Elliott Management) began building its stake in Scottish based FTSE 250 investment group Alliance Trust in 2010.⁹⁵ Although Elliott built a 5% stake in 2012, it doubled its stake to 10% in 2014 and did not announce its public activist agenda until 2015.

When Elliott did announce its activist agenda, it was evident that it had tempered its traditionally publicly aggressive tactics somewhat and had instead engaged in behind-the-scenes discussions with the company.⁹⁶ It also did not launch personal

⁹³ Support Agreement between Third Point and Sotheby's, <<https://www.sec.gov/Archives/edgar/data/823094/000119312514183175/d723453dex997.htm>> accessed 12 February 2018.

⁹⁴ Kelly Crow and Sara Germano, 'Sotheby's CEO to Step Down' *The Wall Street Journal* (New York, 20 November 2014) <<https://www.wsj.com/articles/sothebys-ceo-to-step-down-1416523474>> accessed 12 February 2018.

⁹⁵ Alliance Trust had been subject to an earlier campaign by hedge fund Laxey Partners in 2011. This campaign was unsuccessful and resulted in Laxey Partners exiting in 2012. Elliott did not commence its campaign against Alliance until long after Laxey had retreated, contrary to the wolf pack phenomenon seen in the US. See Judith Evans, 'Alliance Trust investors at heart of hedge fund battle' *Financial Times* (London, 20 March 2015) <<https://www.ft.com/content/dc30269c-cf11-11e4-b761-00144feab7de>> accessed 12 February 2018.

⁹⁶ It was only when Alliance Trust alleged that Elliott had a short-term agenda and had recommended that Alliance Trust undertake a tender offer for 40% of its own shares, that Elliott proceeded to publish the private correspondence between Elliott and Alliance Trust's CEO on its website www.ImproveAllianceTrust.com.

attacks on the CEO, as is typical in public US activist campaigns.⁹⁷ Instead, in March 2015, Elliott simply announced that, as a 12% shareholder, it had nominated three non-executive directors to Alliance Trust's board,⁹⁸ ahead of the company's annual meeting. Elliott's activist campaign was backed by three other large institutional investors, in addition to many of Alliance Trust's 60,000 retail investors, which comprised 70% of the shareholder base.⁹⁹

In April 2015, Alliance Trust settled with Elliott, one day before its AGM. Alliance Trust agreed to add two of Elliott's nominees to the board in return for a one-year standstill agreement until May 2016.¹⁰⁰ In October 2015, the CEO of Alliance Trust stepped down from the board,¹⁰¹ in November 2015, the Chair of the board stepped down,¹⁰² and in February 2016, the CEO left Alliance Trust entirely.¹⁰³

Similar to the Sotheby's example, this campaign can be characterised as quasi-control. Elliott exercised more than influence, adding two directors to the board,

⁹⁷ David Oakley and Miles Johnson, 'Clock ticks for Alliance Trust's Katherine Garrett-Cox' *Financial Times* (London, 1 October 2015) <<https://www.ft.com/content/1951c9bc-682e-11e5-97d0-1456a776a4f5>> accessed 12 February 2018.

⁹⁸ In the UK, under s168(1) Companies Act 2006, shareholders have the power to replace directors at any time. In the US, shareholders have traditionally encountered much greater difficulties in nominating their own directors and have had to resort to expensive proxy contests to secure board representation. The SEC enacted a proxy access rule in 2010 but this was later vacated by the US Court of Appeals for the District of Columbia Circuit in 2011. However, in recent years, many S&P 500 companies have adopted proxy access bylaws, which usually allow shareholders who hold 3% of the shares of a company for at least 3 years the ability to nominate directors without going through a proxy contest.

⁹⁹ David Oakley, Miles Johnson and Clear Barrett, 'Alliance Trust chief gets a year to improve returns after hedge fund truce' *Financial Times* (London, 28 April 2015) <<https://www.ft.com/content/dd2bbfb8-ed6e-11e4-a894-00144feab7de>> accessed 12 February 2018.

¹⁰⁰ Nils Pratley, 'Elliott Advisors wins arm-wrestle with Alliance Trust' *The Guardian* (London, 28 April 2015) <<https://www.theguardian.com/business/nils-pratley-on-finance/2015/apr/28/elliott-advisors-wins-alliance-trust-katherine-garrett-cox>> accessed 12 February 2018.

¹⁰¹ Nishant Kumar and Matt Scuffham, 'Alliance Trust CEO steps down from board as Elliott forces overhaul' *Reuters* (London, 1 October 2015) <<http://uk.reuters.com/article/uk-alliance-trust-ceo-idUKKCN0RV3O420151001>> accessed 12 February 2018.

¹⁰² Chris Newlands and Nathalie Thomas, 'Karin Forseke quits as Alliance Trust chair amid board shake-up' *Financial Times* (London, 27 November 2015) <<https://www.ft.com/content/f89445d4-94d7-11e5-bd82-c1fb87bef7af>> accessed 12 February 2018.

¹⁰³ Chris Newlands, 'Katherine Garrett-Cox to leave Alliance Trust after losing battle' *Financial Times* (London, 15 February 2016) <<https://www.ft.com/content/7863bbd0-d3c8-11e5-829b-8564e7528e54>> accessed 12 February 2018.

and also played a major role in the departure of the CEO and Chair of Alliance Trust. In quasi-control scenarios, the CEO is often ousted, as was the case in both of these examples.

c. Wolf Packs

The phenomenon of ‘wolf pack’ activism by hedge funds has been particularly instrumental in facilitating the market for corporate quasi-control. Wolf pack activism refers to the targeting of a company by more than one activist hedge fund, or a loose network of activist investors acting in a collective or parallel manner.¹⁰⁴ Becht and others estimate that in the last decade, from 2000 to 2010, wolf pack activism accounted for around 20% of all engagements globally and achieved some of the highest returns for target shareholders.¹⁰⁵ Wolf pack activism also tends to be more successful than activism involving a single hedge fund.¹⁰⁶ As wolf pack activism is almost inevitably accompanied by a campaign for board seats, it has a fundamental part to play in the market for corporate quasi-control. Some of the most high profile examples of hedge fund activism involved wolf packs. The prevalence of such activism has also increased in recent years, leading to Martin Lipton calling 2014 “the year of the wolf pack”.¹⁰⁷

Although wolf pack activism can promote the success of the lead activist hedge fund by giving it much needed informational, financial and voting support for its

¹⁰⁴ Coffee and Palia, ‘The Wolf at the Door’ (n 49), 562. See also Strine, ‘Who Bleeds When the Wolves Bite?’ (n 26), 1896-1897.

¹⁰⁵ Based on a dataset of public targets of activism in Asia, Europe and North America. See Marco Becht, Julian Franks, Jeremy Grant and Hannes Wagner, ‘The Returns to Hedge Fund Activism: An International Study’ (2015) ECGI Working Paper No 402/2014, 2, <<https://ssrn.com/abstract=2376271>> accessed 12 February 2018.

¹⁰⁶ Becht and others, ‘The Returns to Hedge Fund Activism’ (n 105), 32 notes that the probability of achieving at least one outcome is 46% for stand alone engagements and 78% for wolf packs.

¹⁰⁷ Martin Lipton, ‘The Threat to Shareholders and the Economy from Activist Hedge Funds’ (*Harvard Law School Forum on Corporate Governance and Financial Regulation*, 14 January 2015) <<https://corpgov.law.harvard.edu/2015/01/14/the-threat-to-shareholders-and-the-economy-from-activist-hedge-funds/>> accessed 12 February 2018.

campaign, wolf packs also present problems for activists. There is a risk of forming a ‘group’ for the purposes of securities regulation in the US, and of engaging in collective action with respect to the mandatory bid rule under the Takeover Code in the UK.¹⁰⁸ The mandatory bid rule in the UK requires any holder of a controlling stake (acquisition of 30% or more of the voting rights in the target’s share capital) to make an offer for the remainder of the target’s share capital.¹⁰⁹ In the US, shareholder activists will be considered a ‘group’ for filing purposes under Section 13(d) of the Securities Exchange Act of 1934 if they have agreed to act together for the purpose of acquiring, holding or voting shares. However, this concept has been construed narrowly so that specific evidence of coordination among shareholders is required in order for them to be deemed a ‘group’.¹¹⁰

In the UK, the Takeover Panel considers persons to be acting in concert where there is an agreement or understanding (whether formal or informal) actively to co-operate through the acquisition by any of them of shares in the company so as to obtain or consolidate control of that company.¹¹¹ ‘Control’ for these purposes is defined more narrowly as: “an interest, or interests, in shares carrying in aggregate 30% or more of the voting rights of a company, irrespective of whether such interest or interests give de facto control.”¹¹² The Code contains particular provisions relating to activist shareholders where it is noted that for the purposes of the mandatory bid rule, the Panel

¹⁰⁸ Not all activist hedge funds pursue the same agendas, even if they form a so-called “wolf pack”. Although they share the same goal of increasing shareholder value, they often employ different strategies to achieve this goal. In Sotheby’s, for instance, Marcato was focused on securing a return of cash to shareholders whereas Third Point sought to oust the CEO and pursue strategic changes.

¹⁰⁹ The City Code on Takeovers and Mergers, Rule 9.1 <<http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/code.pdf?v=12Sep2016>> accessed 12 February 2018. The US has never imposed a mandatory bid rule but does require that the bidder pay the same price for each share it acquires. See Armour and Skeel, ‘Who Writes the Rules for Hostile Takeovers’ (n 8), 1734. See also 1763-1764 for a discussion of the history of the mandatory bid rule in the UK.

¹¹⁰ *CSX Corp v Children’s Investment Fund Management (UK) LLP* 654 F 3d 276 (2d Cir 2011).

¹¹¹ Takeover Code (n 109) Part C1.

¹¹² Takeover Code (n 109) Part C7.

will normally presume shareholders who requisition or threaten a board control-seeking proposal to be acting in concert with their supporters and with the proposed directors.¹¹³ A proposal to appoint or replace only one director will not normally be considered to be board control-seeking. On the other hand, a proposal to replace the entire board or a proposal which would result in the proposed directors representing a majority of the board, will normally be considered to be board control-seeking. Most scenarios lie somewhere in between these two extremes, in which case the Panel takes into account factors such as the board positions being replaced, the mandate of the new directors, whether the activist shareholders will receive any direct or indirect benefits other than through their shareholdings, and the relationships between the new directors and the existing directors and the new directors and the activist shareholders.¹¹⁴ Essentially, the Panel will consider whether the activist shareholders would be in a position to exercise control over the board. In 2009, the Panel issued a Practice Statement on Shareholder Activism, stating that it does not believe that the Code has either the intention or the effect of acting as a barrier to cooperative action by fund managers. In particular, it noted that activist shareholders would only trigger a mandatory offer if both a board control-seeking resolution was sought pursuant to an agreement or understanding between the activists and those shareholders acquire a 30% or higher interest in the company,¹¹⁵ which is an uncommon scenario.

III. Criticisms of Hedge Fund Activism

Despite its potential to promote the markets for corporate influence, quasi-control and

¹¹³ Takeover Code (n 109) Rule 9.1 and Notes to Rule 9.1 (Part F2).

¹¹⁴ Takeover Code (n 109) Notes to Rule 9.1 (Part F3).

¹¹⁵ Takeover Panel Practice Statement No 29, September 2009 <<http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/ps26.pdf>> accessed 12 February 2018.

control, hedge fund activism is criticised for various reasons.

a. Short-Termism

The “sharpest and most comprehensive criticism of hedge fund activism” is the perceived short-term focus of hedge funds, which is argued to be a potential source of long-term value destruction.¹¹⁶ It makes logical sense that hedge fund activists are averse to holding shares for long periods because their business model relies upon them maximising returns on multiple investments then exiting to invest in new targets.

The purported short-termism argument or “myopic-activists” claim proceeds on the basis that the short-term investment horizons of activist hedge funds will induce target company directors and managers to pursue short-term profits and appreciation of the company’s share price at the expense of the long-term success of the company.¹¹⁷

Studies have shown that activism campaigns typically result in short-term gains for shareholders,¹¹⁸ but empirical evidence is more mixed with respect to long-term gains.¹¹⁹ In terms of value creation around the announcement itself, studies have shown

¹¹⁶ Kahan and Rock, ‘Hedge Funds in Corporate Governance’ (n 23), 1083. See also Leo E Strine Jr, ‘One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?’ (2010) 66 *Business Lawyer* 1, 8 and William W Bratton and Michael L Wachter, ‘The Case Against Shareholder Empowerment’ (2010) 158 *University of Pennsylvania Law Review* 653.

¹¹⁷ In 2007 it was noted that the median holding period for activist investments was around 20 months. See Bebchuk, Brav and Jiang, ‘The Long-Term Effects of Hedge Fund Activism’ (n 59), 1087. A related claim, the “counterproductive accountability” claim, is also made by critics of hedge fund activism. This claim proceeds on the basis that the fear of activist hedge fund intervention will lead management itself to initiate and take myopic actions. See Bebchuk, Brav and Jiang, ‘The Long-Term Effects of Hedge Fund Activism’ (n 59), 1095 and Bebchuk, ‘The Myth That Insulating Boards Serves Long-Term Value’ (n 5), 1676-78.

¹¹⁸ Early studies documented the initial short-term share price spikes caused by activist interventions in the US. See, for example, Brav and others, ‘Hedge Fund Activism’ (n 33), 1755-57, Klein and Zur, ‘Entrepreneurial Shareholder Activism’ (n 48), 207-211 and 225-226 and Greenwood and Schor, ‘Investor Activism and Takeovers’ (n 39) 362-375. For more recent data confirming this effect, see Bebchuk, Brav and Jiang, ‘The Long-Term Effects of Hedge Fund Activism’ (n 59), 1121, noting that the average abnormal returns for the 20 day period before and after an investor files a Schedule 13D are approximately 6%. See also Becht and others, ‘The Returns to Hedge Fund Activism’ (n 105) for data across 23 countries.

¹¹⁹ Coffee and Palia, ‘The Wolf at the Door’ (n 49), 551 and Bebchuk, Brav and Jiang, ‘The Long-Term Effects of Hedge Fund Activism’ (n 59), 1155.

that the filing of a Schedule 13D by an activist hedge fund results in large positive average abnormal returns, in the range of 6-8%, and that these are not reversed over time.¹²⁰ However, other studies suggest that there is no statistically significant change in the long-term operating performance of targeted companies.¹²¹ Further studies indicate that activist hedge funds are not in fact short-term in focus, seldom seek control and in most cases are not mainly hostile to incumbent management.¹²²

Another major criticism of hedge fund activism, which is linked to the short-termism argument, is that companies targeted by hedge fund activists may cut research and development (“R&D”) spending, to the detriment of the company and society. Coffee notes that interventions often involve increases in leverage and shareholder payouts and decreases in investment, particularly long-term investment in R&D.¹²³ However, a study by Brav and others argues that firms targeted by hedge fund activists actually experience an improvement in innovation efficiency despite a tightening in research and development expenditures.¹²⁴ Although commentators disagree on whether cuts in R&D are damaging or efficient, it is generally accepted that hedge fund activism is associated with a decline in R&D expenditure in target firms.¹²⁵

¹²⁰ See Brav and others, ‘Hedge Fund Activism’ (n 33), 1730 and Bebchuk, Brav and Jiang, ‘The Long-Term Effects of Hedge Fund Activism’ (n 59), 1122.

¹²¹ See summary of empirical studies of shareholder activism presented in Gillan and Starks, ‘Evolution of Shareholder Activism’ (n 10), 61-62 and 66-67, concluding that the results of studies of the long-term stock performance of targeted companies have been mixed and that virtually all studies of long-term operating performance have reported no statistically significant changes in the operating performance of targeted companies.

¹²² Dionysia Katelouzou, ‘Myths and Realities of Hedge Fund Activism: Some Empirical Evidence’, (2013) 7 Virginia Law and Business Review 459, 477-498.

¹²³ John C Coffee Jr, ‘Hedge Fund Activism: A Guide for the Perplexed’, (*Columbia Law School’s Blog on Corporations and the Capital Markets*, 25 January 2016) <<http://clsbluesky.law.columbia.edu/2016/01/25/hedge-fund-activism-a-guide-for-the-perplexed/>> accessed 12 February 2018.

¹²⁴ Alon Brav, Wei Jiang, Song Ma and Xuan Tian, ‘How Does Hedge Fund Activism Reshape Corporate Innovation?’ (2016) NBER Working Paper No 22273, 36 <<http://www.nber.org/papers/w22273>> accessed 12 February 2018.

¹²⁵ See Coffee and Palia, ‘The Wolf at the Door’ (n 49), 553, 573-577 and Bebchuk, Brav and Jiang, ‘The Long-Term Effects of Hedge Fund Activism’ (n 59), 1136-1138.

Even if short-termism is accepted as a legitimate concern, board insulation and management entrenchment may be just as concerning, if not more concerning. The compensation of boards of directors and the incentives faced by CEOs and other managers largely involve short-term horizons. It has been argued that a typical CEO would weigh results during their own expected tenure above longer-term results.¹²⁶ In addition, the average duration of executive compensation is often shorter than the investment horizon of institutional investors.¹²⁷

b. Hedge Fund Managers as Company Directors

Another common, and perhaps justified, criticism of hedge fund activism is that activist hedge fund managers are unlikely to have a better idea of how to run a company than the incumbent directors.¹²⁸ Approximately 70% of fund-nominated director slates include a hedge fund employee.¹²⁹ Many hedge fund managers, perhaps expert in financial structuring and governance, may lack the experience of serving on a corporate board and may not have the industry expertise that is often required.¹³⁰ When seeking board representation and nominating directors, activist hedge funds have a choice of whether to propose their own investment managers as candidates, or to put forward non-affiliated experienced industry executives. In 2016, 27% of board seats won by hedge fund activists were held by activist fund employees themselves, with the

¹²⁶ See Mark J Roe, 'Corporate Short-Termism-In the Boardroom and in the Courtroom' (2013) 68 *The Business Lawyer* 977 at 980, noting that the average tenure for a CEO in the US is 7 years. In the UK, the average tenure of UK CEO's is 5 years. See Chloe Cornish 'UK chief executives spend less than five years in the job' *Financial Times* <<https://www.ft.com/content/ded1823a-370e-11e7-99bd-13beb0903fa3>> accessed 12 February 2018.

¹²⁷ Roe, 'Corporate Short-Termism' (n 126), 993.

¹²⁸ Stephen M Bainbridge, 'Preserving Director Primacy by Managing Shareholder Interventions' in Hill and Thomas (eds) *Research Handbook* (n 26), 232.

¹²⁹ Coffee and others, 'Activist Directors and Agency Costs' (n 54), 2, 11, 15.

¹³⁰ Yaron Nili, 'Servants of Two Masters? The Feigned Hysteria over Activist-Paid Directors' (2016) 18 *University of Pennsylvania Journal of Business Law* 509, 540.

remaining 73% being held by non-affiliated representatives.¹³¹ In Sotheby's, Third Point's Dan Loeb was elected to the board, together with a restructuring expert and a jewellery designer. Nominating non-affiliated representatives also has the added benefit of outsourcing board director responsibilities so that hedge fund managers can continue to focus on activist strategies at various companies.

Even non-affiliated directors have been criticised for lacking true independence from the activist hedge fund that nominated them. However, it is not an unusual scenario in corporate law for directors to be appointed by and have allegiance to certain subsets of shareholders.¹³² Directors appointed by shareholders in different contexts, such as venture capital and private equity, do not cause controversy. In addition, many so-called 'independent directors' have allegiance to the CEO who appointed them.

A recent study by Coffee, Bishop, Jackson and Mitts also highlights a specific criticism of activist board representation, namely that activist engagements are associated with a short-term increase in information leakage concerning target stock prices and widened bid/ask spreads.¹³³ However, as the leakage results were most notable in cases where an activist hedge fund employee (as opposed to an industry expert) secures board representation, this may provide a strong case for favouring non-affiliated activist board representation. This is further supported by the fact that the study noted that the average 5-day cumulative abnormal return is more than twice as high for settlements involving only non-affiliated directors.¹³⁴

¹³¹ Lazard Review, (n 48), 3.

¹³² Nili, 'Servants of Two Masters' (n 130), 513.

¹³³ Coffee and others, 'Activist Directors and Agency Costs' (n 54), 5.

¹³⁴ Coffee and others, 'Activist Directors and Agency Costs' (n 54), 7, noting a CAR of 4.2% versus a return of 1.9%.

c. Cases of ‘Bad Activism’

A common critique of hostile takeovers was that target companies were not necessarily underperforming. Similarly, this criticism is sometimes directed at hedge fund activism. A company’s poor performance can create opportunities for activists, but past success can equally create such an opportunity.¹³⁵ The empirical evidence is mixed as to whether activists generally target poorly performing companies.¹³⁶ There are certain high profile instances of ‘bad activism’,¹³⁷ where activists have targeted seemingly well-run, profitable companies that have outperformed peer companies in terms of financial and corporate governance metrics.

One commonly cited example is the chemicals giant DuPont, which came under attack by the hedge fund Trian Capital Management. DuPont was one of America’s oldest and largest companies. It had outperformed benchmarks of corporate performance and exceeded the return on the S&P 500 for a number of years.¹³⁸ Nevertheless, in 2015 it became (at the time) the largest public company to ever be subjected to a proxy contest for board seats, with a market cap of approximately \$68 billion.¹³⁹ Trian Capital Management owned approximately 2.7% of the stock and sought four seats on DuPont’s board of directors, including one for its founder Nelson

¹³⁵ Bratton, ‘Hedge Funds and Governance Targets’ (n 26), 1397.

¹³⁶ Bratton, ‘Hedge Funds and Governance Targets’ (n 26), 1399 notes that the overall impression is that targets are split 50/50 between underperformers and overperformers.

¹³⁷ The phrase ‘bad activism’ or ‘bad activist’ is used in recent commentaries on hedge fund activism. See, for example, Jennifer G Hill, ‘Good Activist/Bad Activist: The Rise of International Stewardship Codes’ (2018) 41 *Seattle University Law Review* 497, 498.

¹³⁸ Coffee and Palia, ‘The Wolf at the Door’ (n 49), 555, Steven Davidoff Solomon, ‘In DuPont Fight, Activist Investor Picks a Strong Target’ *The New York Times* (New York, January 28, 2015) <<https://dealbook.nytimes.com/2015/01/27/in-dupont-fight-activist-investor-picks-a-strong-target/>> accessed 1 February 2018 and John C Coffee Jr, ‘The Lessons of DuPont: Corporate Governance for Dummies’, (*The Columbia Law School Blue Sky Blog*, 1 June 2015) <<http://clsbluesky.law.columbia.edu/2015/06/01/the-lessons-of-dupont-corporate-governance-for-dummies/>> accessed 1 February 2018. Trian’s proxy materials argued that the company was underperforming, using a different set of companies as a peer group for DuPont.

¹³⁹ Procter & Gamble is now the biggest company to be the target of a proxy contest. See Part IV Section (a) below.

Peltz as well as three non-affiliated nominees.¹⁴⁰ Trian ultimately won no seats, with all twelve incumbent DuPont directors narrowly securing re-election.¹⁴¹ DuPont's three largest institutional investors, Vanguard, Blackrock and State Street, voted in favour of DuPont's slate, despite proxy advisors Institutional Shareholder Services (ISS) and Glass Lewis supporting Trian's director nominees.¹⁴² Despite Trian's narrow defeat in the proxy contest, the activist fund continued to exert pressure on the company and in less than a year, DuPont's CEO had stepped down and DuPont entered into merger talks with its competitor Dow Chemical (which was also the subject of activist pressure from the hedge fund Third Point).¹⁴³ The companies ultimately merged in a \$143 billion deal in September 2017.

Another commonly cited example of 'bad activism' is the controversial case of Pershing Square's bidder/activist combination in Allergan. This involved the collaboration of the activist hedge fund Pershing Square with a strategic bidder, Valeant Pharmaceuticals, to attempt a hostile takeover of Allergan. This case presented various conflicts of interest, as it involved an unusual profit-sharing collaboration between a strategic bidder and a hedge fund activist to launch a hostile takeover bid together. In April 2014, Pershing Square disclosed a 9.7% stake in Allergan¹⁴⁴ and announced its public support for a merger proposed by Valeant Pharmaceuticals, a proposal that was

¹⁴⁰ Laura Lorenzetti, 'Nelson Peltz takes aim at DuPont board seats as breakup battle continues' *Fortune* (New York, 9 January 2015) <<http://fortune.com/2015/01/09/nelson-peltz-takes-aim-at-dupont-board-seats-as-breakup-battle-continues/>> accessed 12 February 2018.

¹⁴¹ Tom Hals, 'DuPont wins board proxy fight against activist investor Peltz' *Reuters* (Wilmington, 13 May 2015) <<http://www.reuters.com/article/us-dupont-trian-idUSKBN0NY1JI20150513>> accessed 12 February 2018.

¹⁴² Francis J Aquila, 'DuPont's Victory in the Proxy Fight with Trian' (*Harvard Law School Forum on Corporate Governance and Financial Regulation*, 20 May 2015) <<https://corpgov.law.harvard.edu/2015/05/20/duponts-victory-in-the-proxy-fight-with-trian/>> accessed 12 February 2018.

¹⁴³ Lindsay Fortado and Anna Nicolaou, 'Peltz's P&G loss unlikely to stop activist investing tide' *Financial Times* (New York, 11 October 2017) <<https://www.ft.com/content/204792ac-adfe-11e7-beba-5521c713abf4>> accessed 12 February 2018.

¹⁴⁴ Pershing Square Capital Management LP filed its initial Schedule 13D on 21 April 2014, disclosing a 9.7% interest in Allergan (SEC EDGAR database).

rejected by Allergan. Valeant then proceeded to make increased offers, ultimately to the level of approximately \$60 billion.¹⁴⁵ Pershing Square exerted considerable pressure on Allergan to accept Valeant's offers, with Allergan rejecting each bid. In November 2014, Allergan announced a \$66 billion merger with Actavis plc.¹⁴⁶

Pershing Square realised an approximate 55% return on its holding of Allergan shares, which was estimated at \$2.6 billion.¹⁴⁷ Valeant did not acquire a pre-announcement equity stake itself, but it received 15% of the gain on Pershing Square's pre-announcement equity stake, pursuant to the unusual profit-sharing agreement. Pershing Square and Valeant faced an insider-trading lawsuit,¹⁴⁸ filed on behalf of investors who sold Allergan shares, which settled in December 2017.¹⁴⁹ The plaintiffs contended that Pershing Square acquired its stake in Allergan based on non-public information it had received from Valeant that it would make a hostile takeover bid. Allergan itself had also accused Pershing Square and Valeant of insider trading but withdrew the lawsuit when Actavis acquired the company.¹⁵⁰ Allergan also did not escape controversy. On 17 January 2017, the SEC announced a settlement with

¹⁴⁵ David Gelles, 'Valeant and Pershing Square to Raise Offer for Botox Maker Allergan' *The New York Times DealBook* (New York, 7 October 2014) <<https://dealbook.nytimes.com/2014/10/07/valeant-and-pershing-square-to-raise-offer-for-botox-maker-allergan/>> accessed 12 February 2018.

¹⁴⁶ Maria Armental, 'Actavis, Allergan Shareholders Approve \$66 Billion Deal' *The Wall Street Journal* (New York, 10 March 2015) <<https://www.wsj.com/articles/actavis-allergan-shareholders-approve-66-billion-deal-1426020321>> accessed 12 February 2018.

¹⁴⁷ David Gelles, 'No Allergan Deal, but a \$2.6 Billion Profit for Ackman' *The New York Times DealBook* (New York, 17 November 2014) <https://dealbook.nytimes.com/2014/11/17/no-allergan-deal-but-a-2-6-billion-profit-for-ackman/?_r=0> accessed 12 February 2018.

¹⁴⁸ See *Anthony Basile et al v Valeant Pharmaceutical International Inc et al*, SACV 14-2004-DOC, where the defendants' motion to dismiss the lawsuit was denied <http://securities.stanford.edu/filings-documents/1053/AI00_03/20151119_r01x_14CV02004.pdf> accessed 12 February 2018.

¹⁴⁹ Pershing Square and Valeant Pharmaceuticals agreed to pay \$290 million to settle investor claims that they engaged in insider trading (*In re Allergan Inc Proxy Violation Securities Litigation*, 14-cv-02004, U.S. District Court, Central District of California (Santa Ana)). See Edvard Pettersson, 'Pershing Square, Valeant to Pay \$290 Million to End Lawsuit' *Bloomberg* (New York, 29 December 2017) <<https://www.bloomberg.com/news/articles/2017-12-29/pershing-square-valeant-to-pay-290-million-to-end-insider-suit>> accessed 12 February 2018.

¹⁵⁰ Liz Hoffman and David Benoit, 'Allergan, Valeant, Pershing Square Settle Lawsuits Over Takeover Attempt' *The Wall Street Journal* (New York, 9 April 2015) <<https://www.wsj.com/articles/allergan-valeant-pershing-square-settle-lawsuits-over-takeover-attempt-1428593632>> accessed 12 February 2018.

Allergan whereby Allergan agreed to pay a \$15 million penalty. Allergan admitted to violating requirements to update prior disclosure to reflect M&A negotiations the company engaged in following the hostile bid by Valeant, including discussions with an unnamed company and talks with Actavis plc.¹⁵¹ Pershing Square also lost nearly \$4 billion on its Valeant shareholding.¹⁵² Due to the controversy surrounding this case, a bright future for bidder-activist collaborations presently appears doubtful.

The fact that hedge fund activists sometimes target strong performers or engage in so-called ‘bad activism’ is not a convincing argument to shut down the market for corporate quasi-control or hedge fund activism in general. Hedge fund activists argue that “If the ideas are good, they will happen. If they are bad, they won’t get support. It’s hard for activism to be harmful”¹⁵³ and to some extent that is true. If hedge fund activism is on balance positive, it should be encouraged. There are also various safeguards (discussed in Part IV, Section (c) below) that prevent ‘good’ companies from being subjected to corporate quasi-control. Of particular note is that the support of other institutional investors is almost always required in order for activists to succeed. Ordinarily, an activist hedge fund must be able to persuade other institutional investors that its slate of directors and plans for the company would be beneficial for all shareholders.¹⁵⁴

¹⁵¹ Sarah N Lynch, ‘Allergan to pay \$15 million over failing to disclose merger talks’ *Reuters* (New York, 17 January 2017) <<http://www.reuters.com/article/us-sec-allergan-idUSKBN15131B>> accessed 12 February 2018.

¹⁵² David Benoit, ‘William Ackman’s Pershing Square Sold Stake in Valeant’ *The Wall Street Journal* (New York, 13 March 2017) <<https://www.wsj.com/articles/william-ackmans-pershing-square-sold-stake-in-valeant-1489439314>> accessed 12 February 2018.

¹⁵³ Quote from William Ackman, Pershing Square. See ‘An investor calls’ *The Economist* (London, 5 February 2015) <<https://www.economist.com/news/briefing/21642175-sometimes-ill-mannered-speculative-and-wrong-activists-are-rampant-they-will-change-american>> accessed 1 February 2018.

¹⁵⁴ Bebchuk, ‘The Myth of the Shareholder Franchise’ (n 13), 692.

IV. The Value of Activist Directors

a. A Longer-Term Perspective?

The market for corporate quasi-control and activist board representation may reflect and promote longer-term strategies on the part of activist hedge funds. Activists themselves have emphasised that they take longer-term positions in companies when they secure board representation. For example, Jeff Ubben, the head of ValueAct, noted that the fund usually holds investments for two to four years when they hold board seats.¹⁵⁵ In the cases discussed earlier, Third Point has been a shareholder of Sotheby's from 2013 to present,¹⁵⁶ Elliott invested in Alliance Trust from 2010 to 2017 and ValueAct has been invested in Rolls Royce from 2015 to present.¹⁵⁷ Although these are anecdotal examples, they do not exemplify the "hit-and-run" approach commonly associated with activist hedge funds.

In addition to holding shares for longer periods, activist hedge funds seeking board representation now often submit detailed business plans and proposals for long-term strategic and operational improvements at target companies. One such example is the recent proxy contest launched by Trian to obtain one seat for its founder, Nelson Peltz, on the board of Proctor & Gamble ("P&G"). P&G, with a market capitalisation of around \$235 billion, is the largest company ever to be subject to a

¹⁵⁵ 'An investor calls' *The Economist* (n 153).

¹⁵⁶ As at 30 September 2017, Third Point had a 12.69% stake in Sotheby's and Marcato a 1.48% stake. See Third Point's 13F filing with the SEC, <<https://www.sec.gov/Archives/edgar/data/1040273/000108514617002260/0001085146-17-002260-index.htm>> and Marcato's 13F filing with the SEC <<https://www.sec.gov/Archives/edgar/data/1541996/000117266117002041/0001172661-17-002041-index.htm>> both accessed 12 February 2018.

¹⁵⁷ As at 2 February 2018, ValueAct had a 10.94% stake in Rolls Royce. See Rolls-Royce Holdings plc RNS Number 7681D, <<https://markets.ft.com/data/announce/detail?dockey=1323-13519689-17E9ST5G0VS1LNI1LLIORP5FS5>> accessed 12 February 2018.

proxy contest.¹⁵⁸ Trian invested \$3.5 billion in P&G, which gave the activist hedge fund a 1.5% stake in the company. P&G's shareholder base was somewhat unusual for an S&P 500 company as it has a more dispersed shareholder base than is commonly seen. P&G had around three million shareholders, and a high proportion of individual shareholders (generally employees or former employees). The proxy contest is also the most expensive in history, costing Trian \$25 million, with P&G reportedly spending anywhere between \$35 million and \$100 million on its defence.¹⁵⁹ During the campaign, Trian put forward a 93 page whitepaper 'Revitalize P&G Together'¹⁶⁰ which detailed the issues it sought to correct at P&G. Unusually, Martin Lipton, a vocal opponent of hedge fund activism, highlighted that the P&G whitepaper was unique in many ways as Trian was seeking to promote sustainable long-term investment and growth, was not seeking to break up P&G, and was not seeking to cut pensions, reduce R&D, marketing expense or capital expenditures.¹⁶¹ Additionally, Trian was not proposing to replace P&G's current CEO or replace any directors. P&G itself had already engaged in many of the techniques that hedge fund activists are traditionally criticised for, including layoffs, share buybacks, dividend increases and substantial cost cutting.¹⁶² Despite the unusual praise for Trian's campaign, and the support of proxy

¹⁵⁸ This was not P&G's first experience as the target of hedge fund activism. In 2013 it succumbed to pressure from Pershing Square to replace the Chairman and CEO of the company with the former Chairman and CEO. See Jessica Wohl, 'Procter & Gamble brings back former CEO to fix company' *Reuters* (Chicago, 24 May 2013) <<https://www.reuters.com/article/us-procter-ceo/procter-gamble-brings-back-former-ceo-to-fix-company-idUSBRE94M1AW20130524>> accessed 12 February 2018.

¹⁵⁹ Adam Hartung, 'The Case for Trian's Nelson Peltz Joining P&G's Board' *Forbes* (New York, 7 September 2017) <<https://www.forbes.com/sites/adamhartung/2017/09/07/the-case-for-trians-peltz-joining-the-pg-board/#7954396639bb>> accessed 12 February 2018.

¹⁶⁰ Trian Partners, 'Revitalize P&G Together', 6 September 2017, <<https://www.revitalizepg.com/wp-content/uploads/2017/09/Trian-PG-White-Paper-9.6.17.pdf>> accessed 1 February 2018.

¹⁶¹ Martin Lipton, 'The Trian/P&G Proxy Contest' (*The Harvard Law School Forum on Corporate Governance and Financial Regulation*, 11 September 2017) <<https://corpgov.law.harvard.edu/2017/09/11/the-trianpg-proxy-contest/>> accessed 1 February 2018.

¹⁶² See Part V Sections (b) and (c) for a discussion of the future of activist board representation in the context of companies pre-empting potential activist threats, engaging in internal activism and collaborating both with activists and other investors.

advisers ISS and Glass Lewis, in October 2017 the activist was reported to have narrowly lost the proxy contest, by a margin of less than 1%.¹⁶³ However, an independent tally in November 2017 then showed the activist to have won by a margin of 0.0016% and finally in December 2017, P&G conceded that the results were extremely close so they would in fact award Nelson Peltz a seat on the board.¹⁶⁴ Another interesting aspect of this campaign was that five board members who sat on the H J Heinz board of directors with Nelson Peltz sent a testimonial to P&G describing their positive experiences of serving on the board with the activist.¹⁶⁵ In 2006, Nelson Peltz joined the board of Heinz following a hostile proxy contest and he sat on the board of Heinz for seven years. According to the directors' testimonials, despite their strong initial opposition to Peltz joining the board, he proved to be a valued board member who was focused on delivering long-term shareholder value.

One potential reason for the longer-term perspective of hedge funds when they secure board representation may be a regulatory one. In the US, a hedge fund will become an 'insider' that is subject to Section 16 of the Exchange Act if it has a 10% stock ownership or a representative on the company board under the SEC's 'director by deputization' theory.¹⁶⁶ As a result, the activist would have to disclose any change in its

¹⁶³ Shawn Tully, 'Billionaire Investor Nelson Peltz Gives the Blow-by-Blow of His P&G Proxy Fight' *Fortune* (New York, 10 October 2017) <<http://fortune.com/2017/10/10/pg-proxy-results-nelson-peltz/>> accessed 1 February 2018.

¹⁶⁴ The independent count in November 2017 showed Peltz to have won about 42,000 more votes. P&G later said that the certified vote count showed that Peltz had lost by nearly 500,000 shares (of 2 billion votes cast) but that it would increase the size of the board add Peltz as a director as he won almost 50% of votes cast. See Sharon Terlop and David Benoit, 'P&G Concedes Proxy Fight, Adds Nelson Peltz to Its Board' *The Wall Street Journal* (New York, 15 December 2017) <<https://www.wsj.com/articles/p-g-concedes-proxy-fight-adds-nelson-peltz-to-its-board-1513377485>> accessed 12 February 2018.

¹⁶⁵ Triun Partners, 'Revitalize P&G Together' (n 160), 16 and 91.

¹⁶⁶ Securities Exchange Act of 1934 § 16, (codified as amended at 15 U.S.C. § 78p (2012)). Cases on 'director by deputization' may take into account the following factors, among others: the director regularly shares confidential information with the investor; the director has a relationship with the investor that allows the investor to influence the director's decisions; the director has a relationship with the investor that allows the director to routinely influence the investor's investment policy generally or with respect to the issuer; or the director performs his or her duties for the benefit of the investor rather than for the issuer.

interest and would have to disgorge any profits from ‘short-swing’ trading, i.e. trading within any six-month period. This imposes some practical limitations on hedge funds selling stock. There are also often restrictions on selling stock in settlement agreements with activists. For example, in the case of ValueAct and Rolls Royce, ValueAct could only retain its seat on the board provided its stake did not fall below 10%.¹⁶⁷

Another dilemma for hedge funds is how to finally exit the investment once the activist campaign concludes, as offloading large volumes of shares may affect the price realised by the activist. There has been some controversy around so-called ‘hushmail’ transactions, which have been likened to ‘greenmail’ payments in the hostile takeover context. ‘Hushmail’ refers to a practice whereby the activist seeks to have the target company buy back its stock, often at a discount to the market price but occasionally at a premium. For example activist investor KSA Capital sold a 9% stake back to AEP Industries at a 4.5% premium to the market price.¹⁶⁸ In January 2017, Alliance Trust reached an agreement with Elliott to buy back its 19.75% share in the company. The buyback was approved by the shareholders in March 2017, when over 83% of shareholders voted to buy back Elliott’s shares at a discount of 4.75% to net asset value.¹⁶⁹ This was, however, a general share buyback that was extended to Elliott as opposed to a ‘hushmail’ defence.

¹⁶⁷ Relationship Agreement between Rolls-Royce and ValueAct Capital, 2 March 2016, <<https://www.rolls-royce.com/~media/Files/R/Rolls-Royce/documents/about/Key-Terms-of-Relationship-Agreement-with-ValueAct.pdf>> accessed 12 February 2018. For a full discussion of the ValueAct campaign at Rolls-Royce, see Part V, Section (c) below.

¹⁶⁸ The phrase ‘hushmail’ was coined by Texas businessman H. Ross Perot in 1986, to describe an offer made to him by General Motors to buy out his GM stock at a premium price, in exchange for his agreement to stop publicly criticising GM’s management. See Latham & Watkins, ‘Hushmail: Are Activist Hedge Funds Breaking Bad?’ M&A Commentary No 1699, 23 June 2014, <<https://www.lw.com/thoughtLeadership/lw-activist-investors-hushmail>> accessed 12 February 2018.

¹⁶⁹ Maiya Keidan, ‘Alliance Trust investors approve buying back activist investor Elliott’s shares’ *Reuters* (London, 1 March 2017) <<http://uk.reuters.com/article/uk-alliance-tr-elliott-funds-idUKKBN1683UU>> accessed 12 February 2018. Alliance Trust’s share price increased from £3.64 per share when Elliott acquired its 5% stake in November 2012, to £6.81 per share in February 2017 when the share buyback was approved.

b. Non-Affiliated Directors and the Golden Leash

Until recently, it was typical for hedge fund executives themselves to be put forward as the director candidates for activist hedge funds seeking board representation. Prominent activists such as Carl Icahn, William Ackman, Nelson Peltz and Daniel Loeb have served on various company boards and continue to do so.¹⁷⁰ However, it is now increasingly common for hedge funds to nominate non-affiliated directors. As many campaigns for board seats are hostile and face considerable resistance from incumbent directors, it can be difficult to attract independent candidates to become embroiled in activist disputes.¹⁷¹ This led to the creation of ‘golden leash’¹⁷² compensation structures whereby non-affiliated director nominees are compensated by the activist hedge fund in exchange for agreeing to act as the nominee and for achieving specific (usually financial) results at the company once elected to the board. Such compensation structures are extremely controversial, with commentators arguing that “third party bonuses create the wrong incentives, fragment the board and imply a shift toward both the short-term and higher risk”¹⁷³ and stating that “if this nonsense is not illegal, it ought to be”.¹⁷⁴

¹⁷⁰ Matthew D Cain, Jill E Fisch, Sean J Griffith and Steven Davidoff Solomon, ‘How Corporate Governance is Made: The Case of the Golden Leash’ (2016) 164 *University of Pennsylvania Law Review* 649, 665.

¹⁷¹ Nili, ‘Servants of Two Masters’ (n 130), 522-523.

¹⁷² The term “golden leash” was created by Agrium’s Board Chair Victor Zaleschuk in a letter to shareholders surrounding hedge fund Jana’s dissident nominees and their proposed special payments. See Press release of Agrium Inc, <<https://www.sec.gov/Archives/edgar/data/943003/000119312513088716/d495259dex1.htm>> accessed 12 February 2018.

¹⁷³ John C Coffee Jr, ‘Shareholder Activism and Ethics: Are Shareholder Bonuses Incentives or Bribes?’ (*Columbia Law School’s Blog on Corporations and the Capital Markets*, 29 April 2013) <<http://clsbluesky.law.columbia.edu/2013/04/29/shareholder-activism-and-ethics-are-shareholder-bonuses-incentives-or-bribes/>> accessed 1 February 2018.

¹⁷⁴ Stephen Bainbridge, ‘Can corporate directors take third party pay from hedge funds?’ (*Professorbainbridge.com*, 8 April 2013) <<http://www.professorbainbridge.com/professorbainbridgecom/2013/04/can-corporate-directors-take-third-party-pay-from-hedge-funds.html>> accessed 1 February 2018.

Despite their widespread condemnation, I argue that the golden leash, much like activist board representation, could be symptomatic of a new, longer-term commitment on the part of hedge fund activists. The golden leash operates both as a recruitment and commitment device.¹⁷⁵ The monetary incentives from the hedge funds help to facilitate the recruitment of highly qualified directors who usually have much more industry expertise than hedge fund principals. Such individuals may be much better placed than hedge fund employees to challenge corporate strategy or implement a turnaround in a more expert and independent manner. However, directors may be reluctant to serve on a divided board that is attempting a turnaround or other significant corporate change. The nature of the incentives facilitates alignment of the directors' interests with corporate performance and may increase the longevity of the activists' commitment to the company.

A potential criticism of golden leash compensation mechanisms is that remunerating activist appointed directors separately to other board directors may cause less cohesion and collaboration on the board. However, when activists seek board representation at poorly performing companies there are often more pronounced problems of groupthink, long-term ties to corporate incumbents and a lack of diversity of opinions on the board.¹⁷⁶ One such example is the board of Chipotle Mexican Grill, which had been criticised as being emblematic of poor corporate governance. Chipotle had one of the least diverse and least independent boards among the S&P 500 and the

¹⁷⁵ Gregory H Shill, 'The Golden Leash and the Fiduciary Duty of Loyalty', (2017) 64(5) UCLA Law Review, 1246, 1249.

¹⁷⁶ The phrase "groupthink" was coined by Irving Janis, and refers to the tendency of cohesive groups to implicitly censor nonpreferred points of view and indeed any information inconsistent with what is preferred. See Irving L Janis, *Victims of Groupthink* (Houghton Mifflin, 1973) and Donald C Langevoort, 'The Human Nature of Corporate Boards: Law, Norms and the Unintended Consequences of Independence and Accountability' (2001) 89 Georgetown Law Journal 797, 810. See also Stephen Bainbridge, 'Why a Board? Group Decisionmaking in Corporate Governance' (2002) 55 Vanderbilt Law Review, 1, 32, noting that the most significant group bias is the groupthink phenomenon which leads groups to strive for unanimity even at the expense of quality decision making.

median tenure for its directors was 17 years.¹⁷⁷ In such cases, an activist presence on the board could have a profoundly positive impact on board dynamics and corporate governance.

The first publicly discussed case of a golden leash proposal is Jana Partners investment in Canadian fertilizer company Agrium in 2012. Jana agreed to pay its nominees \$50,000 for agreeing to act as a nominee in addition to 2.6% of Jana's net gain on the investment over a three year period.¹⁷⁸ However, Jana's nominees were defeated in the proxy contest so the profit incentive mechanism ultimately did not come to fruition.

The second case where a golden leash was proposed was when Elliott Management targeted oil giant Hess in 2013. Elliott bought a 4.5% stake in Hess and launched a proxy contest to appoint five directors to the company's fourteen-person board.¹⁷⁹ The proposed slate of directors for Hess was comprised of experienced oil and gas executives as opposed to representatives of Elliott. Elliott attempted to incentivise its director nominees with a contingent bonus scheme. This would involve Elliott paying its nominees a one-time cash payment of \$50,000 upon election and further bonuses of \$10,000 for each 1% that Hess shares outperformed the total rate of return

¹⁷⁷ In September 2016, activist hedge fund Pershing Square bought just under 10% of the shares of Chipotle Mexican Grill and pushed for activist board representation. In December 2016, Chipotle reached a settlement with Pershing Square to name four new board members. Two of the new board members were affiliated with the activist and two were independent. It was agreed that the activist-affiliated board members would be included on the company proxy slate for the next two years, during which time Pershing Square would not to comment publicly on the company or increase its investment above 12.9%. See Beth Kowitt, 'Time to Spice Up Chipotle's Board' *Fortune* (New York, 6 December 2016) <<http://fortune.com/2016/12/06/chipotle-board-shake-up-ackman/>> accessed 12 February 2018.

¹⁷⁸ As noted in Cain and others, 'How Corporate Governance is Made' (n 170), 651-652, Jana previously entered into a golden leash compensation arrangement in 2007 in connection with the 2008 annual meeting at CNET Networks and Jana's attempt to add a number of dissident directors to the CNET board. However, the agreement did not receive any public attention and ultimately the compensation scheme did not come to fruition as CNET was sold before the culmination of the proxy contest.

¹⁷⁹ Saabira Chaudhuri, 'Hedge Fund Proposes Revamped Hess Board' *The Wall Street Journal* (New York, 14 May 2013) <<https://www.wsj.com/articles/SB10001424127887324216004578483353992742088>> accessed 1 February 2018.

over the next three years on a control group of large oil industry firms, up to a ceiling of \$9 million.¹⁸⁰

Following a bitter proxy fight that was resolved just hours before the oil company's annual meeting in May 2013, John Hess, who had run the company since 1995, relinquished his chairmanship to an outsider and Elliott was given three board seats in exchange for the hedge fund's support of the company's slate of five directors.¹⁸¹ Ultimately, the golden leash compensation proposal was so controversial that the directors announced that they would waive any such compensation.¹⁸²

The first 'golden leash' compensation structure to actually be implemented was in November 2014 when The Dow Chemical Company reached a negotiated settlement with activist hedge fund Third Point to appoint two non-affiliated nominees to the Dow board.¹⁸³ Third Point's compensation agreement with the nominees included an upfront cash payment of \$250,000 in exchange for serving as a nominee, additional cash payments of \$250,000 if the nominees were appointed as directors of the company, and additional cash payments based on the stock price of Dow after three and five years of service on the board. The two directors were also required to hold at least \$250,000 of Dow stock throughout their board tenure.¹⁸⁴ Importantly, this compensation was given "cautious support" by ISS.¹⁸⁵

¹⁸⁰ Coffee, 'Shareholder Activism and Ethics' (n 173).

¹⁸¹ Michael J De La Merced, 'How Elliott and Hess Settled a Bitter Proxy Battle' *The New York Times* (New York, 16 May 2013) <<http://dealbook.nytimes.com/2013/05/16/hess-and-elliott-settle-fight-over-companys-board/>> accessed 1 February 2018.

¹⁸² Schedule 14A Information, detailing waiver agreements entered into <https://www.sec.gov/Archives/edgar/data/4447/000110465913040504/a13-8112_23dfan14a.htm> accessed 1 February 2018.

¹⁸³ Sayantani Ghosh and Kanika Sikka, 'Dow Chemical, Dan Loeb settle board debate' *Reuters* (New York, 21 November 2014) <<http://uk.reuters.com/article/us-dowchemical-thirdpoint-board-idUSKCN0J51SX20141121>> accessed 1 February 2018.

¹⁸⁴ Nili, 'Servants of Two Masters' (n 130), 527.

¹⁸⁵ David Benoit, 'Proxy Adviser ISS Blesses Pay for Activist's Directors at Dow' *The Wall Street Journal* (New York, 22 April 2015) <<https://www.wsj.com/articles/proxy-adviser-iss-blesses-pay-for-activists-directors-at-dow-1429725478>> accessed 1 February 2018.

The three-year time period in Agrium and Hess, together with the three and five year milestones in Dow could signal a longer investment horizon than is typically associated with hedge fund activists. Therefore, board representation and golden leash compensation structures may mitigate the perceived problem of short-termism to some extent as well as facilitating a market for corporate directors who may prove to be more effective and expert board members than hedge fund managers.

c. Who Monitors the Monitors? – Corporate Governance Intermediaries

In addition to the longer-term perspective hedge fund activists may have when seeking board representation, there are also multiple layers of safeguards that can serve to guard against hedge fund activism that may not be beneficial for the company or its shareholders. Firstly, when non-affiliated directors are nominated by the activist hedge fund, they themselves will likely need to be convinced of the activist's corporate strategy before accepting the nomination. Secondly, those directors are often only elected if other shareholders believe they will add value. If the directors are elected via a proxy contest, shareholders have the opportunity to vote on nominees. In the more common scenario where target companies reach a settlement with activists, shareholders may still be given the ultimate say regarding whether the directors are elected to the board, for example if the directors only recommend that the shareholders vote in favour of the nominees' appointment at the AGM, as was the case in Sotheby's.¹⁸⁶ Even when shareholders are not given the ultimate say, the target company is unlikely to concede board seats to an activist hedge fund that doesn't have broader institutional investor or

¹⁸⁶ See Third Point Support Agreement (n 93) where Sotheby's agreed to use its reasonable best efforts to cause the election of the activist nominees to the company's board, including recommending that the company's shareholders vote in favour of the activist nominees.

proxy advisor support.¹⁸⁷ Moreover, research has shown that even when directors enter the board through settlements, they do not receive less voting support at the following AGM compared to incumbent directors or activist directors who join the board without a settlement.¹⁸⁸ Thirdly, once the activist nominees join the board, they form a minority of the board and the wider board will have to be convinced in order for the proposed changes to be implemented. Finally, directors are bound by fiduciary duties to all shareholders (not simply the hedge fund that appointed them) and must promote the long-term success of the company.¹⁸⁹ An example of these fiduciary duties in action, in the hostile takeover context, is the attempted acquisition of Airgas by Air Products. As part of its takeover attempt, Air Products launched a proxy contest and nominated a slate of three directors to the Airgas staggered board. At the general meeting, all three Air Products nominees were elected to the Airgas board by the Airgas shareholders. However, the board, including the three Air Products nominees, ultimately rejected Air Products' offer.¹⁹⁰

Although institutional investor activism in the 1990s generally proved to be disappointing, the role of institutional investors has evolved and such institutions now

¹⁸⁷ See Gilson and Gordon, 'The Agency Costs of Agency Capitalism' (n 11), 896-901, Brian R Cheffins, 'The Team Production Model as a Paradigm' (2015) 38 Seattle University Law Review 397, 429-430 and Jennifer G Hill, 'The Trajectory of American Corporate Governance: Shareholder Empowerment and Private Ordering Combat' (forthcoming, 2019 University of Illinois Law Review), 6 <<https://ssrn.com/abstract=2921692>> accessed 5 April 2018.

¹⁸⁸ Bebchuk and others, 'Dancing with Activists' (n 7), 5. However, Coffee and others have noted that the study by Bebchuk and others covers results only until 2011 and large diversified institutional investors began voicing their concerns only more recently in 2015 and 2016. See Coffee and others 'Activist Directors and Agency Costs' (n 54), 13.

¹⁸⁹ *eBay Domestic Holdings v Newmark* 16 A 3d 1 (Del Ch 2010), noting that fiduciary duties include acting to promote the value of the corporation for the benefit of its stockholders; s172 of the Companies Act 2006 requires that directors have regard to the long-term consequences of decisions and the need to act fairly as between shareholders of the company.

¹⁹⁰ Nili, 'Servants of Two Masters' (n 130), 542 and Steven M Davidoff, 'Case Study: Air Products v Airgas and the Value of Strategic Judicial Decision-Making' (2012) Columbia Business Law Review 502, 508.

play an increasingly important role in adjudicating corporate governance issues.¹⁹¹ In the US, a small group of institutional investors now own a large proportion of the shares in most public companies.¹⁹² Although institutional investors have recently raised concerns about settlements between target companies and hedge fund activists disenfranchising them,¹⁹³ in reality hedge funds almost always need institutional investor support to succeed in their goals and management needs institutional investor support to defeat hedge fund activists. In fact, the increasing prevalence of hedge fund activist minority board representation was driven by the growing support given to activists by institutional investors and proxy advisory companies.¹⁹⁴ Moreover, if long-term institutional investors are both encouraging and objecting to hedge fund activism, that is likely to be a positive development as it demonstrates they are playing an active role in the governance process, rather than a passive one.

Therefore, there are essentially two arbitrators. Firstly, institutional investor arbitrators, perhaps influenced by other intermediaries such as proxy advisory firms, decide whether to lend their support to hedge fund activists or management. Secondly, the board is the ultimate adjudicator that decides whose recommendations should be followed – the hedge fund activist or incumbent management.¹⁹⁵ Hedge fund activists

¹⁹¹ Kahan and Rock, 'Anti-Activist Poison Pills' (n 90), 3, noting that a new balance of power is emerging in which the largest institutional investors are becoming the de facto "deciders" of corporate governance.

¹⁹² Bebchuk, Cohen and Hirst, 'The Agency Problems of Institutional Investors' (2017) 31 *Journal of Economic Perspectives* (2017) 89, 89.

¹⁹³ See, for example, State Street Global Advisors, 'Protecting Long-Term Shareholder Interests in Activist Engagements', 16 October 2016 <<https://www.ssga.com/our-insights/viewpoints/protecting-long-term-shareholder-interests-in-activist-engagements.html>> accessed 12 February 2018, noting that the recent rise in settlement agreements entered into rapidly between boards and hedge fund activists without the input of long-term shareholders risks favouring short-term priorities over long-term goals and that boards should consider the interests of long-term shareholders when assessing such settlement agreements.

¹⁹⁴ Bebchuk and others, 'Dancing with Activists' (n 7), 4. Institutional investors such as pension funds also invest in activist hedge funds. See Marcel Kahan and Edward B Rock, 'Embattled CEOs' (2010) 88 *Texas Law Review* 987, 1004-1005.

¹⁹⁵ See Bernard S Sharfman, 'Activist Hedge Funds in a World of Board Independence: Creators or Destroyers of Long-Term Value?' (2015) *Columbia Business Law Review* 813, 822 and Jonathan B

can exert significant pressure, especially when their representatives sit on the board, but they cannot force boards to take action unless they take actual control, which is very unusual. Although both adjudicators - institutional investors and the board itself - are subject to biases and potential conflicts of interest, this dual-safeguard should provide protection against potentially value destroying proposals from activist hedge funds. It also means that hedge fund activism can exist within the current model of corporate law whereby the ultimate responsibility for managing the company lies with the board. Overall, with the developments in hedge fund activism, corporate power is distributed more evenly than it was in the age of the imperial CEO.¹⁹⁶

V. The Future of the Market for Corporate Quasi-Control

a. A Revival of the Hostile Takeover Debate

Hedge fund activism is in some respects a similar controversy to the hostile takeover debate a few decades ago. Indeed, some of the 1980s ‘corporate raiders’ in the US, such as Carl Icahn and Nelson Peltz, re-emerged as activist hedge fund managers. Proponents of an effective market for corporate control argued that hostile takeovers target underperforming companies,¹⁹⁷ serve a disciplinary function (unlike the synergistic function served by friendly acquisitions),¹⁹⁸ and ultimately benefit shareholders,

Cohn and Uday Rajan, ‘Optimal Corporate Governance in the Presence of an Activist Investor’ (2013) 26 *The Review of Financial Studies* 985, 1009.

¹⁹⁶ Kahan and Rock, ‘Embattled CEOs’ (n 194), 998-1001.

¹⁹⁷ Randall Morck, Andrei Shleifer and Robert W Vishny, ‘Characteristics of Targets of Hostile and Friendly Takeover Targets’ (1987) NBER Working Paper 2295 <<https://ssrn.com/abstract=227510>> accessed 12 February 2018.

¹⁹⁸ Morck, Shleifer and Vishny ‘Characteristics of Targets of Hostile and Friendly Takeover Targets’ (n 197). However, G. William Schwert, ‘Hostility in Takeovers: In the Eye of the Beholder?’ (2000) 66 *The Journal of Finance* 2599, 2639 notes that most of the characteristics of takeover offers that are related to hostility seem to reflect strategic choices made by the bidder or the target firm to maximise their respective gains from a potential transaction.

companies and society.¹⁹⁹ However, critics of hostile takeovers argued that there is little evidence of poor performance prior to a hostile takeover bid,²⁰⁰ and questioned whether takeover targets actually outperform other companies, post-bid.²⁰¹ Other critics argued that hostile takeovers do not create wealth or produce societal benefits as they simply utilise tax benefits or capture rents and transfer wealth from other stakeholders such as employees and suppliers.²⁰²

Similar arguments can be made regarding hedge fund activism. However, I argue that regardless of the merits of hedge fund activism generally, activist board representation is a potentially positive development that avoids some of the criticisms directed at other forms of hedge fund activism (such as balance sheet activism) which are thought to be short-term in focus. Activist board representation appears to have the potential to benefit companies, shareholders and possibly stakeholders and society more generally. It is beyond the scope of this article to consider the effects of activist board representation on stakeholders. However, the author intends, in future empirical research, to explore the effects of activist board representation not only on shareholders, but also on other stakeholders, such as employees.

¹⁹⁹ Michael C Jensen, 'Takeovers: Their Causes and Consequences' (1988) 2 *Journal of Economic Perspectives* 21.

²⁰⁰ Julian Franks and Colin Mayer, 'Hostile Takeovers and the Correction of Managerial Failure' (1996) 40 *Journal of Financial Economics* 163, find little evidence of poor performance prior to a hostile takeover bid and conclude that hostile takeovers do not perform a disciplinary function (data from 1985-1986); George W Dent, 'Toward Unifying Ownership and Control in the Public Corporation' (1989) *Wisconsin Law Review* 881, 887 argues that tender offers do not strike all mismanaged companies and only mismanaged companies; Simon Deakin and Giles Slinger, 'Hostile Takeovers, Corporate Law, and the Theory of the Firm' (1997) 24 *Journal of Law and Society* 124, 144 argues that the selection of targets does not bear out the disciplinary hypothesis as targets do not, on average, underperform relative to their industrial average.

²⁰¹ Deakin and Slinger, 'Hostile Takeovers' (n 200), 144, argues that there is little proof of a link between hostile bids and post-acquisition corporate performance.

²⁰² Andrei Shleifer and Lawrence H Summers, 'Breach of Trust in Hostile Takeovers' in Alan J Auerbach (ed) *Corporate Takeovers: Causes and Consequences* (Chicago University Press 1988), argue that hostile takeovers involve a wealth transfer from stakeholders to shareholders.

There are also interesting differences between the hostile takeover and hedge fund activism controversies. One such distinction in the US is with regard to changes to corporate law. Whereas the hostile takeover triggered changes in state law and federal securities law, there have been no significant changes to corporate law as a result of hedge fund activism.²⁰³ In particular, proposals to change the regulatory environment with respect to hedge fund activism have not gained much momentum.

Another notable difference concerns defences. The corporate governance landscape has changed significantly from the invention of the poison pill in 1982 to the present day. When the US law firm Wachtell Lipton invented the poison pill, companies were initially cautious to adopt shareholder rights plans. However, after the takeover defence had been tested in the Delaware courts and considerable latitude was given to directors to enact such plans, adoption rates increased. A different story was evident with defences designed to curb hedge fund activism. One such example is the ‘Wachtell Bylaw’ or ‘Director Disqualification Bylaw’. This bylaw was designed to fight ‘golden leash’ compensation arrangements by disqualifying director nominees who received any compensation other than from the company itself. The rapid adoption of this bylaw led to ISS labelling it a “material failure of governance” and recommending that shareholders withhold votes from directors who adopted the bylaw.²⁰⁴ This resulted in widespread retraction of the bylaw²⁰⁵ before it was even tested in the Delaware courts. This highlights that corporate governance intermediaries such as proxy advisors have altered the playing field when it comes to anti-activism defences and history has not entirely repeated itself.

²⁰³ Bratton ‘Hedge Fund Activism’ (n 70).

²⁰⁴ Cain and others, ‘How Corporate Governance is Made’ (n 170), 674.

²⁰⁵ Cain and others, ‘How Corporate Governance is Made’ (n 170), 677.

Hedge fund activism also presents some key advantages compared to hostile takeovers. A hostile takeover is an extreme remedy to discipline corporate managers. In some cases, it may be the most appropriate solution. Ultimately, however, it may be the case that in both the US and the UK, hostile bids were generally viewed as too costly a mechanism to reduce managerial agency costs.²⁰⁶ In many cases, board representation can achieve similar results at a much lower cost. The hostile takeover mechanism also presents additional problems, as bidders must be prepared to sacrifice diversification to buy a controlling stake in the target company.²⁰⁷

Hedge fund activism, on the other hand, is flexible and far reaching - it can promote the market for corporate control, the market for corporate quasi-control and the market for corporate influence. Strategies can be tailored to address specific corporate problems as opposed to being restricted to the draconian measure of a complete change in control. Although hedge fund activism, and in particular proxy contests, are expensive,²⁰⁸ negotiated settlements are now the norm. In addition, neither option encompasses the significant transaction costs typical of a change of control via a hostile takeover.²⁰⁹

²⁰⁶ In both the UK and the US, hostile takeovers are an exceptional, rather than common, occurrence. In the UK, 0.85% of takeovers announced during the period 1990–2005 were hostile, compared with 0.57% in the United States. Of these hostile bids, 43% were successful in the United Kingdom, as opposed to just 24% in the United States. See Armour and Skeel, 'Who Writes the Rules for Hostile Takeovers' (n 8), 1739. See also Gordon, 'The Rise of Independent Directors in the United States' (n 92), 1526–1527.

²⁰⁷ Cheffins and Armour, 'Past, Present and Future of Shareholder Activism' (n 31), 62.

²⁰⁸ The Trian Partners / DuPont proxy fight in 2015 cost the activist \$8 million, while DuPont reportedly spent \$15 million defending it. See Svea Herbst-Bayliss, 'DuPont proxy win may encourage other CEO's to say 'no' to activists' *Reuters* (New York, 13 May 2015) <www.reuters.com/article/duPont-trian-activists-idUSL1N0Y424C20150513>. Recently, the Trian Partners / P&G proxy fight, the biggest and most expensive in history, reportedly cost \$25 million for the activist and anywhere between \$35 million and \$100 million for P&G's defence. See Miles Weiss, 'Peltz, P&G Expect to Spend \$60 Million on Record Proxy Fight' *Bloomberg* (New York, 2 August 2017) <<https://www.bloomberg.com/news/articles/2017-08-02/peltz-and-p-g-expect-to-spend-60-million-on-record-proxy-fight>> both accessed 12 February 2018.

²⁰⁹ See Pound, 'Political Model of Corporate Governance' (n 9), 1009 and 1021 for a discussion of the costs associated with hostile takeovers.

b. Will Activist Board Representation Continue?

The number of board seats sought and secured by activist hedge funds declined slightly in 2017.²¹⁰ This raises the question whether the market for quasi-control in the form of activist board representation will continue at its current pace, or whether it is simply a trend that will later be reversed.

Activist hedge fund tactics constantly evolve. Some activist hedge funds have sought to rebrand themselves as “constructive activists”²¹¹ or “highly-engaged shareholders”.²¹² Hedge funds find new ways to attack or engage with target companies and target companies find new ways to defend or collaborate with hedge fund activists. Following the hostile takeover wave in the 1980s, companies were seen to emulate many of the beneficial attributes of leveraged buyouts.²¹³ Similarly, target companies appear to be reacting to the potential threat of hedge fund activist attacks by emulating many of the beneficial attributes of hedge fund activism. Target companies now often engage in a form of ‘internal activism’ to reduce the company’s vulnerabilities and pre-empt potential activist strikes. For example, following the Kraft-Heinz bid to acquire Unilever, the company pledged to review its business and hit higher profit targets.²¹⁴ Compared to their American counterparts, UK companies already engage in

²¹⁰ There was a decline in the number of board seats won in 2017 (to 100 board seats from 145 in 2016). See Lazard Review 2017 (n 50), 5. This was despite the fact that activists invested \$62 billion in their campaigns in 2017, more than twice the amount of money spent in 2016. See Lindsay Fortado, ‘Investing: activism enters the mainstream’ *Financial Times* (New York: 14 February 2018) <<https://www.ft.com/content/e04547b8-0d0b-11e8-839d-41ca06376bf2>> accessed 14 February 2018.

²¹¹ John Gapper, ‘Beware the Wall Street wolf in constructivist clothing’ *Financial Times* (London, 4 July 2017) <<https://www.ft.com/content/2ab1c654-60c4-11e7-8814-0ac7eb84e5f1>> accessed 12 February 2018, arguing that constructivism is the new activism.

²¹² Lindsay Fortado, ‘Investing: activism enters the mainstream’ (n 210).

²¹³ See Holmström and Kaplan, ‘Corporate Governance and Merger Activity in the United States’ (n 8) 132-133, 136, noting that corporations in the 1990s began to emulate many of the beneficial attributes of leveraged buyouts and that hostile takeovers may no longer have been needed as companies voluntarily restructured and adopted a shareholder value perspective.

²¹⁴ Scheherazade Daneshkhu, ‘Unilever to review business following Kraft Heinz bid’ *Financial Times* (London, 22 February 2017) <<https://www.ft.com/content/f8cbb840-f901-11e6-9516-2d969e0d3b65>> accessed 12 February 2018.

more regular dialogue with institutional investors,²¹⁵ which may partly explain why activist board representation is less prevalent in the UK. Boards in the US also appear to be behaving in a much more proactive manner by initiating dialogue with long-term institutional investors on an ongoing basis, as opposed to waiting until an activist hedge fund strikes. These adaptations on the part of target companies which close off vulnerabilities could reduce the pool of suitable targets for activist board representation campaigns.

c. A New Culture of Collaboration?

In a departure from the aggressive defences used against corporate raiders in the 1980s, there is increasingly a culture of collaboration, or at least settlements, between target companies and hedge fund activists. Indeed, there is nothing to prevent companies from pre-empting activist intervention and proposing changes that activists might advocate before an attack is launched. Although examples of particularly adversarial proxy contests still exist, as recently seen in DuPont and P&G, companies are increasingly recognising the value of collaboration with activists and activism is in many ways becoming less hostile.

Settlement agreements of the sort seen in Sotheby's are now becoming increasingly popular in the US.²¹⁶ Moreover, they have begun to emerge in the UK, as seen in the case of San Francisco based ValueAct Capital's campaign against FTSE 100

²¹⁵ Although UK institutional investors are traditionally passive, especially when it comes to firm-specific intervention (see Armour and Skeel, 'Who Writes the Rules for Hostile Takeovers' (n 8), 1770), there tends to be a much closer relationship between UK corporate boards and their largest investors and boards are more likely to have regular meetings and calls with their shareholders than their US counterparts. See Walker, 'Barbarians in the Boardroom' (n 64), 213-214. The UK Corporate Governance Code 2016 outlines in Supporting Principle E.1 that a company's board should keep in touch with shareholder opinion. Code Provision E.1.2 also dictates that the board should disclose in the annual report the steps they have taken to ensure that they understand the views of major shareholders.

²¹⁶ See Bebchuk and others, 'Dancing with Activists' (n 7), 2.

company Rolls-Royce.²¹⁷ This intervention was the first example of hedge fund activist board representation in a FTSE 100 company and the first known example of a settlement agreement between a hedge fund activist and target company in the UK. In November 2015, ValueAct requested one seat on the Rolls-Royce board, a request that was granted in March 2016.²¹⁸ Rolls-Royce agreed to give ValueAct one board seat in exchange for an undertaking that it would not publicly lobby to break up the company nor increase its stake in the company above 12.5%. Bradley Singer, the COO of ValueAct Capital, was appointed to the board. At the time of writing, ValueAct retains its seat on the board provided that its stake does not fall below 10%, and in certain circumstances, 7.5%.²¹⁹

The increased prevalence of negotiated settlements may, optimistically, reflect a less adversarial and more collaborative approach to activism on the part of both the target companies and the activists.²²⁰ More cynically, one could view settlements as incumbent managers following the path of least resistance and seeking to avoid adverse publicity or a defeat in a proxy contest, or hoping to retain their executive positions if

²¹⁷ ValueAct announced a 5.44% stake in FTSE 100 Rolls-Royce in July 2015. Rolls-Royce was undoubtedly an underperforming company, with a plummeting share price and multiple profit warnings in recent years. ValueAct's stake was increased to 10% in November 2015, making it Rolls-Royce's largest shareholder. The activist campaigned for cost cuts, disposals and a change in strategy. See Miles Johnson and Peggy Hollinger, 'US activist fund becomes largest Rolls-Royce shareholder' *Financial Times* (London, 31 July 2015) <<https://www.ft.com/content/58212f4c-3792-11e5-b05b-b01debd57852>> and Robert Wall, 'ValueAct Capital Bolsters Stake in Rolls-Royce' *The Wall Street Journal* (New York, 19 November 2015) <<http://www.wsj.com/articles/valueact-capital-bolsters-stake-in-rolls-royce-1447943355>>, both accessed 12 February 2018.

²¹⁸ Peggy Hollinger, 'Rolls-Royce agrees ValueAct board deal' *Financial Times* (London, 2 March 2016) <<https://www.ft.com/content/3809a222-e04b-11e5-9217-6ae3733a2cd1>> accessed 12 February 2018.

²¹⁹ Relationship Agreement between Rolls-Royce and ValueAct Capital (n 167).

²²⁰ Some institutional investors have recently pushed back against settlements. See Michael Flaherty, 'Big funds push back against activist investor settlements' *Reuters* (New York, 18 July 2016) <<http://www.reuters.com/article/us-activist-investors-idUSKCN0ZY2DP>> accessed 18 February 2018. Long-term institutional investors also continue to emphasise the importance of target boards engaging with them. For example, in BlackRock's annual letter to shareholders, CEO Larry Fink urged companies to engage with long-term shareholders early and bring other critical stakeholders to the table when activists offer valuable ideas. See Larry Fink's Annual Letter to CEOs, January 2018, <<https://www.blackrock.com/corporate/en-no/investor-relations/larry-fink-ceo-letter>> accessed 12 February 2018.

they appease hedge fund activists with board seats. Regardless of the underlying motives of company directors, activists are undoubtedly becoming increasingly successful at swiftly obtaining board representation. Companies often emphasise that they are working cooperatively with activists and reach agreements with activists during the early stages of intervention. One recent example is Jana Partners' agreement with Tiffany & Co to add three non-affiliated directors to the Tiffany board, which was announced before the market was even aware that the activist was a 5% shareholder.²²¹ A recent study, which considered settlements from 2000-2011, noted that over 87% of settlements stipulate activist board representation.²²² Some companies have even gone so far as to invite activist intervention. For example, General Electric's CEO invited activist Nelson Peltz of Trian Partners, which did not own shares in the company, to become involved in GE. Trian ultimately invested \$2.5 billion, which was its biggest investment to date at the time.²²³

Conclusion

Hedge funds have been described as the "prime corporate governance and control activists".²²⁴ Yet activist hedge funds continue to be routinely villainised as short-term actors in corporate governance debates. I argue that such criticisms are outdated and unjustified as they do not accurately reflect the reality of many recent activist engagements. Although I acknowledge that not all activist campaigns are positive, I

²²¹ Michael Flaherty, 'Tiffany adds three directors in pact with activist JANA' *Reuters* (London, 21 February 2017) <<http://uk.reuters.com/article/us-tiffany-jana-idUKKBN1601AC>> accessed 12 February 2018.

²²² Bebchuk and others, 'Dancing with Activists' (n 7), 16.

²²³ David Benoit, 'Activism's Long Road From Corporate Raiding to Banner Year: Change in tactics let industry move beyond controversial past' *The Wall Street Journal* (New York, 26 December 2015) <<https://www.wsj.com/articles/activisms-long-road-from-corporate-raiding-to-banner-year-1451070910>> accessed 12 February 2018. Trian's biggest investment at the time of writing is now its \$3.5 billion investment in P&G.

²²⁴ Kahan and Rock, 'Hedge Funds in Corporate Governance' (n 23), 1091.

have identified recent developments in hedge fund activism that challenge the traditional negative rhetoric, with a particular focus on the redeeming features of the market for corporate quasi-control and activist board representation. Initial evidence from cases where hedge funds have sought and secured representation on target company boards suggests that hedge funds may demonstrate longer-term investment horizons and a stronger commitment to improving operations and corporate strategy when they seek board representation, compared to when they pursue more traditional types of hedge fund activism, such as balance-sheet activism. Therefore, some of the typical criticisms of hedge fund activism appear to be effectively mitigated by this phenomenon, and the market for corporate quasi-control could potentially provide a flexible and innovative solution to agency problems in public companies. I suggest that this trend towards a longer-term outlook and a more in-depth focus on the substantive strategic and operational changes a company can implement to improve performance is reflective of a more general evolution of hedge fund activism towards closer collaboration with companies and other long-term investors.

In addition to promoting the market for corporate quasi-control, activist hedge funds seeking board representation have also encouraged the development of an active market for expert board members, by recruiting non-affiliated candidates to serve on target company boards and by incentivising them through golden leash compensation mechanisms. The available evidence points clearly towards this approach to board representation being superior to hedge fund managers serving on company boards themselves. Although non-affiliated candidates still likely pursue a similar activist agenda, they may offer their diverse perspectives in a less confrontational manner, which can reduce the potential disruption to board dynamics and functioning.

Non-affiliated candidates also often have valuable turnaround or industry expertise that hedge fund managers ordinarily lack.

Hedge fund activists, through the market for corporate quasi-control, have also mobilised previously passive institutional investors to act as invaluable corporate governance intermediaries. Despite some recent criticisms regarding the potential disenfranchisement of long-term institutional investors in activist settlements, such shareholders usually play a crucial and significant role in the success or failure of activist campaigns. This adjudication acts a safeguard against hedge fund activism that may not be beneficial for the company or its shareholders.

Whether activist board representation will continue at its current pace remains to be seen. Hedge fund activists essentially rely on weaknesses and vulnerabilities at target companies to fuel their campaigns, together with the associated discontent of longer-term investors. As companies increasingly try to pre-empt activist campaigns by emulating the attributes of hedge fund activism and engaging more proactively with long-term investors, the pool of appropriate prospective targets could potentially shrink. However, it may be unrealistic and overoptimistic to expect such a dramatic reduction in agency costs at public companies. A more likely scenario is that hedge funds will continue to have multiple opportunities to exploit, which should assure the survival and potential growth of activist board representation, at least in the near future.