ACTIVIST HEDGE FUNDS IN A WORLD OF BOARD INDEPENDENCE: CREATORS OR DESTROYERS OF LONG-TERM VALUE?

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Numerous empirical studies have shown that hedge fund activism has led to enhanced returns to investors and increased firm performance. Nevertheless, leading figures in the corporate governance world have taken issue with these studies and have argued that hedge fund activism leads to long-term value destruction.

This Article argues that an activist hedge fund creates long-term value by signaling to the board of directors ("Board") that its executive management team may be making inefficient decisions and providing recommendations on how the company should proceed in light of those inefficiencies. These recommendations require the Board to review and question the direction executive management is taking the company and then choose which path the company should take: the one recommended by executive management, the one recommended by the activist hedge fund, or a combination of both. This argument relies on the existence of a Board that can act as an independent arbitrator in deciding whose recommendations should be followed.

In addition, this Article discusses the implications for shareholder voting when an activist hedge fund interacts with an independent Board. Finally, it gives an explanation for why activist hedge funds do not provide recommendations that involve long-term investment.

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I. INTRODUCTION

Numerous empirical studies have shown that hedge fund activism has led to enhanced returns to investors and increased firm performance.[1] Some scholars explain these

[1] *See generally* Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729 (2008) [hereinafter Brav et al., *Hedge Fund Activism*]; April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187 (2009);

results by arguing that activist hedge funds act as a corrective mechanism in the corporate governance of a public company, leading to higher stock prices and better company performance.[2]

Nevertheless, leading figures in the corporate governance world, most notably Martin Lipton, have disagreed with these studies and have argued that hedge fund activism leads to long-term value destruction:

> While there is no question that almost every attack, or even rumor of an attack, by an activist hedge fund will result in an immediate increase in the stock market price of the target, such gains are not necessarily indicative of real value creation. To the contrary, the attacks and the efforts by companies to adopt short-term strategies to avoid becoming a

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Nicole M. Boyson & Robert M. Mooradian, *Corporate Governance and Hedge Fund Activism*, 14 REV. DERIVATIVES RES. 169 (2011); Christopher P. Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists*, 14 J. CORP. FIN. 323 (2008); Robin Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON. 362 (2009); Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015) C.N.V. Krishnan, Frank Partnoy & Randall S. Thomas, *Top Hedge Funds: The Importance of Reputation in Shareholder Activism* (2015), http://ssrn.com/abstract=2589992 [http://perma.cc/9H3K-E9FU]. *See also* Shane Goodwin, Myopic Investor Myth Debunked: The Long-Term Efficacy of Shareholder Advocacy in the Boardroom 11–12 (June 13, 2014) (working paper), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2450214 [http://perma.cc/5ZLS-225P] (finding the retention of gains over a five-year period in the context of an activist hedge fund gaining Board representation). For empirical results consistent with these studies but focusing on hedge fund activity outside the United States, see Dionysia Katelouzou, *Myths and Realities of Hedge Fund Activism: Some Empirical Evidence*, 7 VA. L. & BUS. REV. 459, 479 (2013).

2 Paul Rose & Bernard S. Sharfman, *Shareholder Activism as a Corrective Mechanism in Corporate Governance*, 2014 BYU L. REV. 1015, 1050–51 (2015) (failing to address the implications of executive management acting as a separate locus of authority in the corporate governance of a public company and thus distinguishing itself from the present Article, which addresses the implications of executive management being delegated a large amount of decision-making authority).

> target have had very serious adverse effects on the companies, their long-term shareholders, and the American economy.[3]

If so, then the actions of activist hedge funds allegedly compel public companies to enter into detrimental short-term strategies in order to be removed from the activists' target list.[4] This is something akin to greenmail where the corporation must deplete its resources to make the hostile bidder go away.[5] Moreover, according to Lipton, the strategies of activist hedge funds are meant to achieve short-term gains without regard to the welfare of the companies they target:

> Institutional investors on average own more than 70% of the shares of the major public companies. Their voting power is being harnessed by a gaggle of activist hedge funds who troll through SEC filings looking for opportunities to demand a change in a company's strategy or portfolio that will create a

3 Martin Lipton, *Empiricism and Experience; Activism and Short-Termism; the Real World of Business*, HARVARD LAW SCHOOL FORUM ON CORP. GOVERNANCE & FIN. REGULATION (Oct. 28, 2013), http://blogs.law.harvard.edu/corpgov/2013/10/28/empiricism-and-experience-activism-and-short-termism-the-real-world-of-business/ [http://perma.cc/WQZ9-6J2Y]. *See also* Bill George & Jay W. Lorsch, *How to Outsmart Activist Investors*, HARV. BUS. REV., May 2014, 88, 90 ("We remain unconvinced, however, that hedge fund activism is a positive trend for U.S. corporations and the economy; in fact, we find that it reinforces short-termism and excessive attention to financial metrics."); Stephen Bainbridge, *Dennis Berman on the Activist Hedge Funds Short-term Playbook*, PROFESSORBAINBRIDGE.COM (Jan. 28, 2015, 10:35 AM), http://www.professorbainbridge.com/professorbainbridgecom/2015/01/dennis-berman-on-the-activist-hedge-funds-short-term-playbook.html [http://perma.cc/N4F7-ZJN2] (agreeing that the problem with hedge fund activism is its focus on the short term).

4 Lipton, *supra* note 3.

5 Cheff v. Mathes, 199 A.2d 548, 548 (Del. 1964) (dealing with a case where Board repurchased shares at a price above market to get hostile bidder to go away and not attempt to gain control).

> short-term profit without regard to the impact on the company's long-term prospects.[6]

The short-term profit presumably refers to the capital gain that would accrue to the activist hedge fund after buying a significant amount of company shares and then selling those shares for a higher price at the end of its relatively short investment horizon.[7] Allegedly, an increase in the price of a company's shares resulting from the recommendations of the activist hedge fund can be harmful to a company's long-term fortunes. This paradoxical understanding of how such recommendations affect corporate governance is referred to as "short-termism":

> Short-termism refers to companies taking actions that are profitable in the short term but value-decreasing in the long term, such as increasing near-term earnings by cutting research that would pay off later on. Activist investors with short investment horizons, it is argued, seek actions that boost short-term stock price at the expense of long-term value and often succeed in pressuring companies to take such actions.[8]

6 Martin Lipton, *Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy*, HARVARD LAW SCHOOL FORUM ON CORP. GOVERNANCE & FIN. REGULATION (Feb. 26, 2013), http://blogs.law.harvard.edu/corpgov/2013/02/26/bite-the-apple-poison-the-apple-paralyze-the-company-wreck-the-economy/ [http://perma.cc/CQY7-4P48].

7 *See* Brav et al., *Hedge Fund Activism*, *supra* note 1, at 1732 (estimating holding periods of activist hedge funds to average around 20 months); Alon Brav, Wei Jiang & Hyunseob Kim, *Hedge Fund Activism: A Review*, 4 FOUND. & TRENDS FIN. 185, 204 (2009) (reporting a 266-day median period between Schedule 13D filing and divestment).

8 Lucian A. Bebchuk, *The Myth that Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1638–39 (2013). *See also* Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265, 268 (2011) (defining short-termism as "the excessive focus of corporate managers, asset managers, investors, and analysts on short-term results, whether quarterly earnings or short-term portfolio returns, and a repudiation of concern for long-term value creation and the fundamental value of firms.").

According to then-Vice Chancellor Leo Strine (currently the Chief Justice of the Delaware Supreme Court):

> [M]any activist investors hold their stock for a very short period of time and may have the potential to reap profits based on short-term trading strategies that arbitrage corporate policies . . . . [T]here is a danger that activist stockholders will make proposals motivated by interests other than maximizing the long-term, sustainable profitability of the corporation.[9]

These allegations imply that activist hedge funds operate in a very predictable and somewhat unbelievable fashion. First, they make a significant investment in the company. Second, they fool other investors into believing their recommendations are wealth-enhancing. Third, their recommendations *force* Boards to respond by taking actions that have the effect of increasing the share price of the company, but only in the short term. Fourth, after a relatively short holding period, activist hedge funds sell their shares in the company but prior to the other shareholders' finding out that the company's long-term value has been damaged.[10] As a result, activist hedge funds may be perceived as being no better than the executives of public

9 Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 8 (2010).

10 Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1084 (2007) ("For the short-term trading horizon of hedge funds to generate a short-term investment outlook for hedge fund managers, the stock market must suffer from *myopia*: that is, it must undervalue long-term investments relative to short-term investments. If the market does not itself suffer from such a bias, then the interests of investors with short-term trading horizons will not conflict with those of investors with long-term trading horizons."). *See also* George W. Dent, Jr., *The Essential Unity of Shareholders and the Myth of Investor Short-Termism*, 35 DEL. J. CORP. L. 97, 116–19, 122–28 (2010) (arguing that this alleged short-termism on the part of institutional investors, including hedge funds, is of dubious validity and noting that such short-termism has not been empirically verified).

companies when they act to manipulate company operations and strategies to increase reported short-term profits at the expense of *long-term value*.

As one would suspect, the supporters of the short-termism argument minimize the informational value of the empirical studies that show hedge fund activism to be beneficial to shareholders and to enhance the operating performance of the companies it targets. It is not surprising that the methodologies of the numerous empirical studies demonstrating the benefits of hedge fund activism have been criticized by those with significant knowledge of statistical methods.[11] After all, that is the normal part of the vetting process for such studies. However, it is surprising that some of the most prominent corporate law figures of our time, most notably Martin Lipton (the inventor of the poison pill and the leading corporate law practitioner of his time), the Honorable Leo Strine (Chief Justice of the Delaware Supreme Court), and Stephen Bainbridge (the leading academic proponent of corporate law's traditional model of corporate governance), have rejected these studies outright,[12]

11 YVAN ALLAIRE & FRANÇOIS DAUPHIN, INST. FOR GOVERNANCE OF PRIVATE & PUBLIC ORGS., "ACTIVIST" HEDGE FUNDS: CREATORS OF LASTING WEALTH? WHAT DO THE EMPIRICAL STUDIES REALLY SAY?, 6 (July 2014), http://igopp.org/wp-content/uploads/2014/07/IGOPP_Article_Template2014_Activism_EN_v6.pdf [http://perma.cc/TN6F-R9HX] ("Econometrics provides a crude tool kit, a weak lens through which the researcher can, at best, view the blurred contours of complex phenomena."); YVAN ALLAIRE & FRANÇOIS DAUPHIN, INST. FOR GOVERNANCE OF PRIVATE & PUBLIC ORGS, STILL UNANSWERED QUESTIONS (AND NEW ONES) TO BEBCHUK, BRAV AND JIANG (Jan. 2015), http://igopp.org/wp-content/uploads/2015/01/Allaire-Dauphin-Still-unanswered-question-and-new-ones_January-19-2015_v2.pdf [http://perma.cc/2TBE-KMAU]; John C. Coffee, Jr. & Darius Palia, *The Impact of Hedge Fund Activism: Evidence and Implications* 4–5 (European Corp. Governance Inst., Working Paper No. 266, 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2496518 [http://perma.cc/V74R-Q4ZL].

12 Martin Lipton, *The Bebchuk Syllogism,* HARVARD LAW SCHOOL FORUM ON CORP. GOVERNANCE & FIN. REGULATION (Aug. 26, 2013), http://blogs.law.harvard.edu/corpgov/2013/08/26/the-bebchuk-syllogism/ [http://perma.cc/DS46-LUUC] ("No empirical study, with imperfect proxies for value creation and flawed attempts to isolate the effects of activism

cast significant doubt on their value,[13] or at least have taken the position that their use in corporate governance is premature.[14] In response, Lucian Bebchuk, Alon Brav, and Wei Jiang strongly urge, "Don't Run Away from the Evidence."[15]

But why would these noted corporate law leaders run away from the evidence? A plausible explanation is that these leaders are first and foremost corporate law experts who buy into corporate law's approach to corporate governance. That approach is what Michael Dooley would call the "Authority Model"[16] of corporate governance or what

over a long-term horizon influenced by varying economic, market and firm-specific conditions, is capable of measuring the damage done to American companies and the American economy by the short-term focus that dominates both investment strategy and business-management strategy today.").

13 Leo E. Strine Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 461–62 (2014) ("I must admit to having a healthy skepticism whenever the 'law AMPERSAND' movement cranks up its machinery and tries to prove empirically a contestable proposition about a complicated question involving the governance of a human community of any kind."); Stephen M. Bainbridge, *Everything The Economist Says About Shareholder Activism is Wrong*, PROFESSORBAINBRIDGE.COM (Feb. 13, 2014, 5:41 PM), http://www.professorbainbridge.com/professorbainbridgecom/2014/02/everything-the-economist-says-about-shareholder-activism-is-wrong.html [http://perma.cc/RU9U-D5SX] ("I am just saying that all empirical studies need to be taken with a grain of salt and those by folks with an agenda need a larger than usual grain."); ALLAIRE & DAUPHIN, "ACTIVIST" HEDGE FUNDS, *supra* note 11, at 6; ALLAIRE & DAUPHIN, STILL UNANSWERED QUESTIONS, *supra* note 11, at 9, 15.

14 Coffee & Palia, *supra* note 11, at 4–5.

15 Lucian Bebchuk, Alon Brav & Wei Jiang, *Don't Run Away from the Evidence: A Reply to Wachtell Lipton*, HARVARD LAW SCHOOL FORUM ON CORP. GOVERNANCE & FIN. REGULATION (Sept. 17, 2013), http://corpgov.law.harvard.edu/2013/09/17/dont-run-away-from-the-evidence-a-reply-to-wachtell-lipton/ [http://perma.cc/B7X7-YWPV].

16 *See* Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 463 (1992) (referring to two models of corporate governance, the "Authority Model" and the "Responsibility Model," of which the former dominates corporate law). In *Two Models of Corporate Governance*, Professor Michael Dooley was the first to make the connection

Stephen Bainbridge would call "Director Primacy."[17] That model of corporate governance is powerfully summarized in Stephen Bainbridge's statement that the "[p]reservation of managerial discretion should always be the null hypothesis."[18]

Corporate law concentrates decision-making authority in the Board because it recognizes that a centralized, hierarchical authority is necessary for the successful management of a corporation, especially if it is a public company. Michael Dooley observed that the value of centralized authority in an organization, such as in a public company, is magnified as the knowledge and interests of its members diverge.[19] For those who believe in such a model of corporate governance, the only thing that can reject the null hypothesis is the judicial review of a Board's decision for a breach of its fiduciary duties. There is no room for a non-managerial locus of authority in corporate governance if that locus of authority, such as an activist hedge fund, shifts decision-making away from the Board.

Fortunately, there is no need to reject the null hypothesis in order to argue hedge fund activism provides significant value for the corporate governance of a public company. Presented here is a new argument in support of hedge fund

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between the work of Kenneth Arrow and the structure of Delaware corporate law. *Id.* at 467.

17 Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance,* 97 NW. U. L. REV. 547, 550 (2003) [hereinafter Bainbridge, *Director Primacy*]; Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1, 7 (2002).

18 Steven M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 109 (2004) [hereinafter Bainbridge, *The Business Judgment Rule*]. For a blog post summarizing this issue with corporate law leaders, see Bernard S. Sharfman, *Why Run Away from the Evidence?*, HARVARD LAW SCHOOL FORUM ON CORP. GOVERNANCE & FIN. REGULATION (May 7, 2015), http://corpgov.law.harvard.edu/2015/05/07/why-run-away-from-the-evidence/ [http://perma.cc/GFW3-9SYF].

19 Dooley, *supra* note 16, at 467 ("Where the residual claimants are not expected to run the firm and especially when they are many in number (thus increasing disparities in information and interests), their function becomes specialized to risk-bearing, thereby creating both the opportunity and necessity for managerial specialists.").

activism that does not imply that decision-making is shifted from the Board. This Article argues that an activist hedge fund creates long-term value by both signaling to the Board that its executive management team may be making inefficient decisions and providing recommendations on how the company should proceed. These recommendations require the Board to review and question the direction executive management is taking the company and then choose which path the company should take: the one recommended by executive management, the one recommended by the activist hedge fund, or a combination of both. This argument relies on the ability of the Board to act as an independent arbitrator deciding whose recommendations should be followed. This process can be summarized in the following thesis statement: An activist hedge fund can create long-term value at a public company if the Board has enough independence to act as an impartial arbitrator deciding between the advice provided by executive management and the activist hedge fund.

The exclusive focus of this Article is on the corporate governance of public companies. For purposes of this Article, a public company can be defined as a for-profit corporation that is publicly traded on a national exchange or over-the-counter, but does not have a controlling shareholder. This type of company is susceptible to the influence of an activist hedge fund.

The discussion that follows, when it references state corporate law, has been pragmatically framed in the context of Delaware corporate law. Delaware is the state where the majority of the largest U.S. companies are incorporated,[20] and its corporate law often serves as the authority that other

20 *See* LEWIS S. BLACK, JR., WHY CORPORATIONS CHOOSE DELAWARE 1 (2007), delaware.gov/whycorporations_web.pdf [http://perma.cc/8VFU-ZVZJ] (stating that Delaware is the "favored state of incorporation for U.S. businesses . . . ."). According to the State of Delaware website, Delaware is the legal home to "[m]ore than 50% of all publicly-traded companies in the United States including 64% of the Fortune 500." *About Agency,* STATE OF DEL., http://corp.delaware.gov/aboutagency.shtml [http://perma.cc/7V3E-9EFU].

U.S. states look to when developing their own statutory and case law.[21] Therefore, the primary examples are from Delaware, but the Article is meant to be global in nature.

This Article proceeds as follows. Part II describes hedge fund activism and how it works. Part III explains the distinct role that activist hedge funds play in the stock market. Part IV defines "long-term value creation," an essential requirement prior to determining if hedge fund activism creates or destroys long-term value. Part V provides an integrated model of corporate governance that the activist hedge fund must deal with and be a part of. This model incorporates (i) decision-making authority provided by corporate law, (ii) stock market signals provided by the stock market to the independent Board of a public company, and (iii) a rationale for why the Board should be receptive to those signals in order to create long-term value. Part VI discusses the implications for shareholder voting when an activist hedge fund interacts with an independent Board. Part VII explains the relatively limited types of recommendations provided by activist hedge funds and why they are still value enhancing. Part VIII concludes by summarizing this Article's findings and recommendations.

II. WHAT IS HEDGE FUND ACTIVISM AND HOW DOES IT WORK?

Hedge fund activism[22] is a type of shareholder activism. Shareholder activism can be defined as "any action(s) of any shareholder or shareholder group with the purpose of bringing about change within a public company *without trying to gain control*."[23] Shareholder activism can be divided

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

22 Hedge fund activism is more formally referred to as offensive shareholder activism. *See* Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 56–57 (2011).

23 Rose & Sharfman, *supra* note 2, at 1017. Professor Andreas Jansson describes shareholder activism as outside shareholders who

into non-performance-driven and performance-driven activism. Non-performance-driven activism focuses on changes in a public company's governance arrangements, executive compensation, and social policy.[24] Performance-driven activism focuses on advocating for significant changes in corporate strategy to increase the market price of a company's stock.[25] Hedge fund activism is a type of performance-driven activism. Hedge fund activism can also be distinguished from another type of peformance-driven activism, defensive shareholder activism. Unlike hedge fund activism, defensive shareholder activism is reactionary, with institutional investors only becoming dissatisifed with the company's performance subsequent to their investment.[26]

Hedge fund activism typically begins with a relatively unregulated investment fund (the hedge fund) accumulating a significant amount of a public company's stock, usually around five to ten percent of the shares outstanding.[27] The activist hedge fund makes purchases based on its determination that the target company is suffering from

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"influence corporate insiders . . . by voicing their opinions in order to affect corporate behavior." Andreas Jansson, *No Exit!: The Logic of Defensive Shareholder Activism*, 10 CORP. BOARD: ROLE, DUTIES & COMPOSITION 16, 16 (2014).

24 *See* JAMES R. COPLAND, YEVGENIY FEYMAN & MARGARET O'KEEFE, MANHATTAN INST. CTR. FOR LEGAL POL'Y, PROXY MONITOR 2012: A REPORT ON CORPORATE GOVERNANCE AND SHAREHOLDER ACTIVISM 1, 11 (2012), http://www.proxymonitor.org/forms/pmr_04.aspx [http://perma.cc/9KPP-GV8L].

25 Rose & Sharfman, *supra* note 2, at 1018.

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

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

Kahan & Rock, *supra* note 10, at 1069 (footnote omitted).

27 *See* Cheffins & Armour, *supra* note 22, at 56.

significant *managerial inefficiencies*. It believes that if management adopts its recommended strategies, then the value of the company's common stock would significantly increase and the company's performance would improve.[28]

In order for an activist hedge fund to maximize returns, it cannot hold the target company's stock for a long period of time.[29] Once it removes the perceived impediment to shareholder wealth maximization at the target company, it must move on to the next corporation in order to maximize its number of interventions, and thus the profits of its own investors.[30] It is not possible for long-term investors like Warren Buffett and Berkshire Hathaway to participate in such corrective activism precisely because they have such long holding periods.[31] Therefore, such long-term investors must yield this market to activist hedge funds.

The threat of a proxy contest may be the most important weapon the activist hedge fund has in its arsenal to effect change. In 2013, activist hedge funds initiated twenty-four of the thirty-five proxy contests conducted with respect to Russell 3000 companies.[32] They also won nineteen of these twenty-four contests.[33] However, as these numbers suggest, the threat of a proxy contest appears to be more important to the activist hedge fund than actually engaging in one. Brav, Jiang, Partnoy, and Thomas report that only thirteen percent of hedge fund activism (as represented primarily by a hedge fund's filing of an SEC form Schedule 13D) resulted in a proxy contest, while Klein and Zur reported that only

28 *Id.*

29 Holding periods of activist hedge funds are estimated to average around 20 months. *See* Brav et al., *Hedge Fund Activism, supra* note 1, at 1732.

30 Rose & Sharfman, *supra* note 2, at 1046.

31 *Id.*

32 Coffee & Palia, supra note 11, at 12 (citing RICHARD LEE & JASON D. SCHLOETZER, THE CONFERENCE BD., DIRECTOR NOTES: THE ACTIVISM OF CARL ICAHN AND BILL ACKMAN 1, 2 (May 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2442317 [http://perma.cc/K33Q-CV88]).

33 *Id.*

twelve percent of offensive shareholder activism initiated by hedge funds and other activists resulted in a proxy contest.[34]

But just because many activist hedge funds enter into settlement agreements in advance of running an actual proxy contest does not mean that they refrain from seeking Board representation. Activist hedge funds still do gain Board representation. According to Shane Goodwin, between 1996 and 2013, 739 activist interventions resulted in the granting of at least one Board seat to an activist shareholder.[35] Moreover, representation without control appears to suit the needs of the activist hedge fund. Coffee and Palia speculate that since shareholders would be unwilling to provide control (via a proxy contest) to an activist hedge fund without a control premium, such representation on the Board, though minimal, allows the activist to push a specific agenda ("e.g., the spinoff of a division, a higher dividend payout, a stock buyback, etc.").[36]

In addition, "the targets of hedge fund activism exhibit relatively high trading liquidity, institutional ownership, and analyst coverage. Essentially, these characteristics allow the activist investors to accumulate significant stakes in the target firms quickly without adverse price impact, and to get more support for their agendas from fellow sophisticated investors."[37] Such targets allow for the potential of wolf packs to develop. A wolf pack is made up of a "loose network of activist investors" able to "take collective (or, at least, parallel) action without forming a 'group' for purposes of the federal securities laws (which would trigger an earlier disclosure obligation)."[38] Through the process of informal signaling, the lead activist hedge fund can put extra pressure

34 Brav et al., *Hedge Fund Activism*, *supra* note 1, at 1743; Klein & Zur, *supra* note 1, at 213, 215.

35 Goodwin, *supra* note 1, at 52.

36 Coffee & Palia, *supra* note 11, at 19–20.

37 *See* Brav et al., *Hedge Fund Activism: A Review*, *supra* note 7, at 4.

38 *See* Coffee & Palia, *supra* note 11, at 3, 23.

on the Board knowing that it has the support of a significant share base held by other hedge funds.[39]

III. WHAT MAKES AN ACTIVIST HEDGE FUND UNIQUE?

The activist hedge fund is a stock market participant and can be described in that context as a special type of *information trader*.[40] The information trader is "willing and able to devote resources to gathering and analyzing information as a basis for its investment decisions."[41] Information traders look for differences between value and price based on the information they possess and "then trade to capture the value of their informational advantage."[42] Information traders move security prices toward their fundamental values and are in essence "the agents who render markets efficient."[43]

Activist hedge funds need to be distinguished from the more common type of information trader, the *value investor*. Value investors devote whatever limited time, resources, and skill they have to valuation, not to the process of trying to correct managerial inefficiencies through an attempt to

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[39] Brav, Dasgupta, and Mathews found that "[h]olding constant total activist ownership, the presence of a lead activist increases the probability of successful activism due to improved coordination among activists." Alon Brav, Amil Dasgupta & Richmond Mathews, *Wolf Pack Activism* (2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2529230 [http://perma.cc/BM9H-HZV6].

[40] Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 721–23 (2006). Non-information traders include *insiders* such as directors and executive management who have access to non-public information but are significantly restricted in the trading of that information; *liquidity traders* who invest in passive, index funds; *noise traders* who invest based on fads, rumors or old information; and *market makers*, professionals who facilitate trading and maintain a market for securities by offering to buy or sell securities on a regular basis. *Id.* at 720–26.

[41] *Id.* at 723.

[42] *Id.* at 726.

[43] *Id.* at 719.

acquire control or hedge fund activism.[44] Value investors incorporate information on *managerial inefficiencies* into the price of a company's stock by *voting with their feet*,[45] i.e., selling their shares when they perceive managerial inefficiencies, rather than becoming proactive in the corporate governance of any particular firm.[46] It should be expected that a significant number, if not most, of information traders are "value investors."[47] This should not be surprising since becoming an acquirer or an activist hedge fund means not just identifying managerial inefficiencies, but also raising large amounts of capital in order to acquire or make a significant investment in the company. It also requires possessing the skill necessary to implement the necessary changes. Moreover, becoming an acquirer or activist hedge fund may mean giving up the benefits of portfolio diversification as the acquisition becomes an overweighed investment in the information trader's portfolio, exposing the trader to non-systematic risk.

44 Rose & Sharfman, *supra* note 2, at 1033.

45 According to Professors Armen Alchian and Harold Demsetz in their seminal article, *Production, Information Costs, and Economic Organization*, "[a]ny shareholder can remove his wealth from control by those with whom he has differences of opinion. Rather than try to control the decisions of the management, which is harder to do with many stockholders than with only a few, unrestricted salability provides a more acceptable escape to each stockholder from continued policies with which he disagrees." Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 788 (1972).

46 Bernard S. Sharfman, *A Theory of Shareholder Activism and its Place in Corporate Law*, 82 TENN. L. REV. (forthcoming 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2549757 [http://perma.cc/MLJ2-QTV5].

47 Gilson and Gordon refer to institutional investors who are value investors (earn returns based on fundamental analysis and diversification) as "rationally reticent." Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 867 (2013). They vote, but they do not propose or get involved in trying to influence the management of the corporation. *See id.*

Like value investors, activist hedge funds are information traders that provide signals on managerial inefficiencies to the Boards of public companies. However, they are distinguished from value investors by their willingness to "take large positions in public companies as a means to effect change,"[48] to spend resources to identify strategic changes that they believe will increase the share price of the targeted public company, and then to spend even more resources to try to get the company to implement those changes.[49] The actions of the activist hedge fund provide additional and confirming signals to the Board and other stock market participants that managerial inefficiencies may exist at the company. But most importantly, they provide recommendations that the Board can consider to correct the alleged inefficiencies. In essence, they are information traders who take on the additional role of shareholder activist to correct managerial inefficiencies.[50] Unlike value investors, they do not vote with their feet.

If indeed the objective of activist hedge funds is to correct managerial inefficiencies, then their actions are consistent with the following thesis:

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48 Bernard S. Sharfman, *What's Wrong with Shareholder Empowerment?*, 37 J. CORP. L. 903, 906–07 (2012).

49 Cheffins & Armour, *supra* note 22, at 56–58.

50 Brav, Jiang, and Kim's empirical research is consistent with this description:

> The significant coefficients on the valuation variable, *q* (defined as (book value of debt + market value of equity)/(book value of debt + book value of equity)), indicate that the activist hedge funds resemble "value investors." This result suggests that activist hedge funds attempt to identify undervalued companies where the potential for improvement is high. In fact, in about two-thirds of the cases, the hedge fund explicitly states that it believes the target is undervalued. To the extent that activist hedge funds profit from the improvement of the companies' operations and strategies, it is also important that hedge funds target companies whose stock prices have yet to reflect the potential for improvement.

See Brav et al., *supra* note 7, at 207.

> **Thesis:** In the context of public companies, shareholder activism may constitute a valuable asset in and of itself if the goal of such activism is to enhance managerial efficiency.[51]

This thesis is essentially a subdued form of Henry Manne's thesis regarding the market for corporate control. Both begin with Manne's premise that there exists "a high positive correlation between corporate managerial efficiency and the market price of shares of that company."[52] Such a premise means that the price of a public company's stock will in part reflect managerial performance. Manne used this premise to argue that "the control of corporations may constitute a valuable asset" in and of itself, an asset that "exists independent of any interest in either economics of scale or monopoly profits," if the acquirer takes control with the expectation of correcting managerial inefficiencies.[53]

"Paradoxically," value investors "who have the necessary information, but do not participate in the market for corporate control, create the foundation for its success."[54] Moreover a "critical assumption surrounding the market for corporate control" is that value investors would "rather sell their shares than attempt to acquire control."[55] However, a low share price[56] resulting from a significant number of value investors *voting with their feet* does provide an opportunity for an information trader to make the investment necessary to acquire control and use its expertise

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51 Sharfman, *supra* note 46.

52 Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965).

53 *Id.*

54 Sharfman, *supra* note 46.

55 *Id.*

56 According to Manne, "[t]he lower the stock price, relative to what it could be with more efficient management, the more attractive the take-over becomes to those who believe that they can manage the company more efficiently. And the potential return from the successful take-over and revitalization of poorly run company can be enormous." Manne, *supra* note 52, at 113.

to correct the managerial inefficiencies.[57] Once these inefficiencies have been corrected, the information trader can then sell its investment for a large profit if it so desires.[58]

In order to determine successful hedge fund activism, the theory of shareholder activism depends upon the same principles as the market for corporate control. A low share price provides opportunities for the activist hedge fund to buy low, provide recommendations that will be implemented by the Board, and then sell for a profit. This assumes that the activist holds enough shares in the company to earn a large enough return on the expected increase in the stock price to cover the costs of its activism.[59] If so, then successful hedge fund activism benefits all shareholders.[60] Such activism also has the attributes of a public good as the activists absorb all costs privately but share the value created with all other public shareholders.[61]

IV. DEFINING *LONG-TERM VALUE CREATION*

Having a common understanding of what is meant by "long-term value creation" is critical to having a productive discussion regarding the merits of hedge fund activism. However, this term is rarely defined in the debate, an omission that should not be allowed to continue if the ongoing debate is to have any productive value.

A. Defining *Value*

To begin, defining long-term value creation means having an understanding of what is meant by a firm having *value*. From a corporate finance perspective, the approach taken here, a firm creates value by generating enough cash inflows to cover its cash outflows. However, that still does not provide a complete picture of whether or not a firm has

57 Sharfman, *supra* note 46.

58 *Id.*

59 *Id.*

60 *Id.*

61 Jansson, *supra* note 23, at 16.

value. The timing of the inflows and outflows must then be discounted by the proper interest rate to determine if they have a positive net present value. If they do, then the firm has value.

Moreover, if the net present value of a firm's net cash flows is the proper definition of a firm's value, then continuously making investments with present values expected to be positive should lead to long-term value creation. Such a process can be referred to as *sustainable value creation*.

However, if we want to make sure that sustainable value creation has the best chance of occurring at any point in time, then the management of a public company should also have the responsibility of trying to maximize this net present value as part of its decision-making calculus. Hence, long-term value creation is equivalent to maximizing a firm's net present value.[62] This maximization is what the Board and executive management should be striving to achieve.

B. Investment Time Horizon

Defining what is meant by *long-term* is another issue that must be dealt with up-front. Fortunately, the Delaware Supreme Court in *Paramount Communications, Inc. v. Time Inc.* provides us with excellent guidance:

> [W]e think it unwise to place undue emphasis upon long-term versus short-term corporate strategy . . . . Delaware law imposes on a board of directors the duty to manage the business and affairs of the corporation. 8 Del.C. § 141(a). This broad mandate

[62] The Boston Consulting Group provides a definition of sustainable value creation that places itself in the middle ground between the definition used above and this Article's definition of long-term value creation. "By definition, sustainable value creation means delivering superior shareholder returns over the long term, by which we mean over a decade or more, not just a few years." *See* ERIC OLSEN ET AL., BOSTON CONSULTING GRP., SEARCHING FOR SUSTAINABILITY: VALUE CREATION IN AN ERA OF DIMINISHED EXPECTATIONS 7 (2009), http://www.bcg.com/documents/file31738.pdf [http://perma.cc/UBN7-BXKB]. However, why the definition stops short of including shareholder wealth maximization is not clear.

> includes a conferred authority to set a corporate course of action, including time frame, designed to enhance corporate profitability. Thus, the question of "long-term" versus "short-term" values is largely irrelevant because directors, generally, are obliged to chart a course for a corporation which is in its best interests without regard to a fixed investment horizon.[63]

Thus, the meaning of "long-term" cannot be characterized by being greater than any specific number of days, months, or years. It simply depends on the situation. The lack of a minimum period of time associated with the definition may appear to make the term trivial, but this is not correct. As discussed in Section D of this Part, "long-term" as an adjective of "value creation" refers to the process of how a Board and its executive management go about implementing value creation over the foreseeable future and beyond.

C. For the Benefit of Shareholders

The next question that needs to be asked is for whose benefit are the Board and executive management maximizing net present value? If it is accepted that shareholders are the sole claimants on the residual cash flows generated by the firm, since other parties transacting with the corporation can adequately protect themselves by contract,[64] then this definition of long-term value creation is

[63] Paramount Comm'ns Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989).

[64] This would include communities who provide tax credits and abatements to companies who agree to remain or relocate to their geographic area, vendors who customize their production to provide specialized inputs, and researchers who invest many years of specialized effort and skill as employees, three examples of other parties that transact with public companies via contract. Under a team production approach to corporate governance, an approach that is not taken here, these three examples would represent persons or entities that make specialized investments in the public company that have little or no value outside the company. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 272 (1999). Like equity investors, these stakeholders have made firm-specific investments and

equivalent to shareholder wealth maximization.[65] Hence, long-term value creation equals maximizing a firm's net present value, which equates to shareholder wealth maximization.

A special result occurs when shareholder wealth maximization is defined to be equivalent to long-term value creation. This equivalency allows for the expectation that a unity of purpose exists between corporate management and those shareholders who seek to correct managerial efficiencies through shareholder activism. While there may be disagreement between shareholders and the Board regarding the correct strategy the corporation should implement, at least there will be no disagreement on the ultimate corporate objective, giving the company the best opportunity to maximize shareholder wealth.

D. Implementing Long-Term Value Creation

But how is long-term value creation to take place in the real world decision-making of a public company? First, this requires an ongoing process of corporate decision-making that is not biased toward short-term or long-term investment horizons at any point in time. The company's Board, as the default locus of authority for all corporate decision-making,[66] and executive management, with its decision-making authority delegated to it by the Board,[67] must evaluate all

therefore should have equivalent standing as claimants on the residual cash flows generated by the firm. *Id.* at 274–76.

65 Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2065 (2001) ("The prevailing academic and business view in the United States is that shareholder wealth maximization fits with a utilitarian, greatest-good-for-the-greatest-number philosophy.").

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

67 The Delaware General Corporation Law provides that "[e]very corporation organized under this chapter shall have such officers with such titles and duties as shall be stated in the bylaws or in a resolution of

profitable opportunities available to the company, no matter what the investment horizon, and then pick those opportunities that have the expectation of maximizing the present value of the company's cash flows given whatever constraints the company may face in terms of financing and other finite resources. Therefore, creating long-term value does not restrict the Board to considering only those profitable investment projects or strategies that have the longest time horizons. That is, there is nothing wrong with a portfolio of short and intermediate investment horizon products and strategies if that is what maximizes shareholder wealth at any decision point in time. According to Mark Roe, "the long term is not to be preferred, just for its own sake, if it yields poorer returns and wastes resources."[68] Conversely, the Board cannot be biased against profitable investment projects or strategies that may not come to fruition for many years. If this bias exists, then the decision makers can be accused of short-termism.

Perhaps most importantly, this is an "intrinsic value,"[69] not a "market value" approach to corporate governance. That is, the role of the Board and its executive management is not to directly maximize the market price of the company's shares, but to maximize the "intrinsic value" of the company's shares.[70] It is noteworthy that the Delaware

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the board of directors which is not inconsistent with the bylaws." DEL. CODE ANN. tit. 8, § 142(a) (2010).

68 Mark J. Roe, *Corporate Short-Termism—In the Boardroom and in the Courtroom*, 68 BUS. LAW. 977, 981 (2013).

69 There are five basic assumptions that underlie the "intrinsic value" approach to corporate governance: (1) the Board has private information as to company value, (2) there are barriers to this information being communicated to the market, (3) the valuation gap between valuations based on the company's private versus the market's public information can be large, (4) valuation gaps persist over a significant period of time, and (5) the market for corporate control cannot eliminate the valuation gaps. Richard E. Kihlstrom & Michael L. Wachter, *Corporate Policy and the Coherence of Delaware Takeover Law*, 152 U. PA. L. REV. 523, 534 n.34 (2003).

70 Henry T.C. Hu, *Efficient Markets and the Law: A Predictable Past and an Uncertain Future*, 4 ANN. REV. FIN. ECON. 179, 203 (2012). *See also*

courts have endorsed the "intrinsic value" approach since the landmark case of *Smith v. Van Gorkom*.[71] According to the Delaware Supreme Court in *Paramount Communications, Inc. v. Time Inc.*, "it is not a breach of faith for directors to determine that the present stock market price of shares is not representative of true value or that there may indeed be several market values for any corporation's stock."[72]

For purposes of corporate governance, this approach is quite reasonable as the market price only reflects public information while the Board and executive management have available confidential information on which to base their decisions. Unfortunately, it is not empirically known how much informational asymmetry exists between management and shareholders at any public company at any point in time.[73] It may be a little, it may be a lot; the extent of the asymmetry may be unknowable.[74] However, it is beyond doubt that information asymmetries do exist[75] and that shareholders, including activist hedge funds, are at an informational disadvantage relative to directors. Of course, as the confidential information eventually becomes public, the market price should eventually reflect this previously confidential information, but the duration of this process from confidential to public is not known.[76]

Second, it is not enough that the Board and its executive management do a great job in identifying opportunities that allow for long-term value creation/shareholder wealth

Roger J. Dennis, *Valuing the Firm and the Development of Delaware Corporate Law*, 17 RUTGERS L.J. 1, 9 (1985).

71 Smith v. Van Gorkom, 488 A.2d 858, 876 (Del. 1985). In *Van Gorkom*, the court stated: "The fact that the Board had no reasonably adequate information indicative of the intrinsic value of the Company, other than a concededly depressed market price, was without question material to the shareholders voting on the merger." *Id.* at 890.

72 Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1150 n.12 (Del. 1990) (citing *Van Gorkom*, 488 A.2d at 876).

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

74 *Id.*

75 *Id.*

76 *Id.*

maximization. It must also have the *management skills* and *financing expertise* to implement these opportunities in the most cost efficient manner. Finally, while creating the best operating software, smart phone, or internet search engine may be the stated goal of the company and can often lead to unimagined wealth (i.e., Microsoft, Apple, and Google respectively), such an approach is only desirable if it coincides with the objective of maximizing the net present value of the firm. After all, we are talking about for-profit organizations, not non-profit universities, foundations, institutes of research, or charities.

E. Summary

Long-term value creation means a decision-making process where management strives to maximize a firm's net present value. Such an approach equates long-term value creation with maximizing shareholder wealth. For purposes of implementation, the key point is that long-term value creation requires management at public companies to always take a maximization approach in its decision-making. To implement such an approach, management must take a present value approach to identifying its investments and strategies, an unbiased approach to short-term versus long-term investments and strategies, and an intrinsic, not market, value approach to maximization in order to take advantage of private information; utilize expert management skills in implementing projects; and understand that achieving big ideas is fine as long as it intersects with shareholder wealth maximization.

Such a process lends itself to hedge fund activism. A breakdown in one or more of the steps in this process means that the company has the potential to do a much better job in creating long-term value for its shareholders. Eventually, value investors will signal to the rest of the market that a breakdown has occurred, sending the price of a company's stock downward. If management does not correct the process, then the next step is for an activist hedge fund to intervene by investing in the target company's common stock and providing recommendations for correcting the managerial inefficiencies that currently exist.

V. AN INTEGRATED MODEL OF CORPORATE GOVERNANCE

So far, we have described hedge fund activism, the unique characteristics of an activist hedge fund as a stock market participant, and what it means to create long-term value at a public company. Whether or not hedge fund activism creates or destroys long-term value is dependent on how the corporate governance structure of a public company allows the information provided by activist hedge funds to be incorporated into the company's decision-making. Board independence plays a key role in how effectively this information can be incorporated.

A. Corporate Law and the Corporate Governance Structure of a Public Company

The corporate governance structure of a public company has as its foundation the default rules provided by corporate law. Under corporate law, the Board is the default locus of authority for corporate decision-making.[77] However, corporate law authorizes the Board to delegate the bulk of its decision-making authority to executive management.[78] This locus of authority created by delegation, separate from but under the control of the Board, not only runs the company on a day-to-day basis but also provides the Board with recommendations on what investment projects and strategies the company should proceed with and then implements them with Board approval. Conversely, corporate law does not provide hedge fund activism with any overt support. While there is nothing stopping activists from engaging the Board either publicly or privately to advocate for a change in corporate strategies, corporate law provides little support for their recommendations outside of allowing

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

78 DEL. CODE ANN. tit. 8, § 142(a) (2010).

them the opportunity to threaten or enter into a proxy contest, file either a direct or derivative lawsuit for a breach of a Board's fiduciary duties, propose and vote on binding bylaw proposals,[79] which may include the nomination of directors through proxy access,[80] or propose and vote on non-binding proposals if the Board cannot exclude them from the company proxy statement under SEC rules.[81] Given this lack of overt legal endorsement, what role is the activist hedge fund to play in the corporate governance of a public company?

B. The Independent Board

Board composition is critical in allowing the activist hedge fund to play a significant role in the corporate governance of a public company. While not required by statutory corporate law, "independent directors" have composed a majority or supermajority of Boards for many years.[82] According to Margaret Blair and Lynn Stout, "an

79 *See* DEL. CODE ANN. tit. 8, § 109 (2011); Blair & Stout, *supra* note 64, at 260–61.

80 SEC Rule 14a-8(i)(8) provides that companies will be permitted to exclude a shareholder proposal if it:

> (i) Would disqualify a nominee who is standing for election;
> (ii) Would remove a director from office before his or her term expired;
> (iii) Questions the competence, business judgment, or character of one or more nominees or directors;
> (iv) Seeks to include a specific individual in the company's proxy materials for election to the board of directors; or
> (v) Otherwise could affect the outcome of the upcoming election of directors.

17 C.F.R. § 240.14a-8(i)(8) (2013).

81 17 C.F.R. § 240.14a-8(i) (2013).

82 According to a recent report by Spencer Stuart, eighty-four percent of S&P 500 Boards were composed of independent directors. *See* SPENCER STUART, SPENCER STUART BOARD INDEX 2014 8 (2014), https://www.nyse.com/publicdocs/nyse/listing/Spencer_Stuart_Board_Index_2014.pdf [https://perma.cc/manage/vest/3WJR-FPBR]. Moreover, "the CEO has become the sole non-independent director on the majority of boards. On 58% of boards today, the CEO is the only non-independent

independent board is what makes a public corporation a public corporation."[83] According to Stephen Bainbridge, "a unique attribute of the modern public corporation is the ever-increasing use of independent board members who typically lack both day-to-day management power and any significant equity stake in the corporation."[84] Independence ideally means "independence of mind" when participating in the making of a Board decision.[85]

To make sure the Board of a public company has an adequate level of independence, the listing requirements of the U.S. stock markets state that the Board of a public company must be composed of a majority of independent directors; the independence determination is based on a number of subjective and objective rules.[86] These rules focus on keeping the Board independent of management.[87] For

director, compared with 50% in 2009. In 2004, 61% of boards had at least one non-independent director in addition to the CEO." *Id.* at 15.

83 Blair & Stout, *supra* note 64, at 251.

84 Bainbridge, *Director Primacy*, *supra* note 17, at 561; Bainbridge, *The Board of Directors as Nexus of Contracts*, *supra* note 17, at 27 n.114.

85 John Roberts, Terry McNulty & Philip Stiles, *Beyond Agency Conceptions of the Work of the Non-Executive Director: Creating Accountability in the Boardroom*, 16 BRIT. J. MGMT. S5, S19 (2005) ("[W]e have argued that independence is only significant within a board in the form of a willingness to exercise independence of mind in relation to executive strategy and performance.").

86 A key focus of the major U.S. stock exchanges is to make sure that the Board of a listed company is composed of a majority of independent directors. In general, independent directors can be defined as directors whose ties to the corporation are not so significant as to influence their judgment in corporate matters. The stock exchanges set out both subjective and objective tests for establishing director independence. *See, e.g.*, N.Y. STOCK EXCH., LISTED COMPANY MANUAL §§ 303A.01–.02 (2009), http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4&manual=%2Flcm%2Fsections%2Flcm-sections%2F [http://perma.cc/M52E-RUXN] (explaining how the test for establishing director independence is a two-part objective and subjective one).

87 Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 450 (2008) ("The Sarbanes-Oxley Act of 2002 (SOX) and the self-regulatory organizations (SROs) such as the NASDAQ and the New York Stock Exchange (NYSE) define independence by way of status: 'independence' means outsider status.").

example, "[n]o director qualifies as 'independent' unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company)."[88]

Delaware corporate law takes a different approach to independence. It does not require independence, but does provide significant deference to the decision-making of a Board that is composed of a majority of independent members.[89] However, its focus is on situational independence, and therefore does not specifically target keeping management at arm's length from directors.[90] For example, under Delaware law, a court determines whether a director is independent by asking "whether a director, although lacking in a financial self-interest, is somehow 'beholden' to an individual who is interested, or whose

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88 N.Y. STOCK EXCH., LISTED COMPANY MANUAL § 303A.02(a)(i) (2009).

89 For example, independence is a requirement in order for the Board to receive the deferential business judgment rule when one of its decisions has been challenged. According to the Delaware Chancery Court in *Robotti & Co. v. Liddell*:

> The business judgment rule, as a general matter, protects directors from liability for their decisions so long as there exist "a business decision, disinterestedness and *independence*, due care, good faith and no abuse of discretion and a challenged decision does not constitute fraud, illegality, ultra vires conduct or waste." There is a presumption that directors have acted in accordance with each of these elements, and this presumption cannot be overcome unless the complaint pleads specific facts demonstrating otherwise.

Robotti & Co., LLC v. Liddell, C.A. No. 3128-VCN, 2010 Del. Ch. LEXIS 4, at *46–47 (Jan. 14, 2010) (citing STEPHEN A. RADIN ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES FOR CORPORATE DIRECTORS 110 (6th ed. 2009)).

90 Rodrigues, *supra* note 87, at 466 ("In Delaware, unlike under SOX, the NYSE, or NASDAQ, one cannot determine independence or interest ex ante. One must instead ask: 'Independent for what purpose? Independence from whom?' Defining independence in isolation is impossible because the challenged transaction holds the key.").

decisions are not based on the corporate merits, but rather are influenced by 'personal or extraneous considerations.'"[91]

As discussed below, an adequately independent Board allows the best opportunity for external performance signals to be incorporated into corporate decision-making.

C. The Value of Stock Market Signals

For Boards, executive management, and information traders alike, it is important to identify when their respective companies are underperforming due to managerial inefficiencies. Fortunately, the stock market, through value investors who vote with their feet and thereby put downward pressure on the price of a company's shares, provides clear and unbiased signals[92] that companies are being inefficient in their selection or implementation of investment opportunities and strategies.

Such information does not necessarily mean that company decisions destroy long-term value. These signals may just as likely indicate that management could be doing a better job in maximizing its opportunities and getting closer to reaching its objective of long-term value creation and shareholder wealth maximization. Moreover, it is important to be clear that this price fall is a signal, not affirmation, that managerial inefficiencies may actually exist at a public company. As already mentioned, corporate insiders have access to confidential information that stock market participants do not have. Even though value investors will do their own research to profit from the private

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[91] *Id.* (quoting Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 362 (Del. 1993)).

[92] According to Henry Manne, "[a]part from the stock market, we have no objective standard of managerial efficiency." Manne, *supra* note 52, at 113. This comment is consistent with the "efficient capital market theory." According to Daniel Fischel, "[t]wo major implications of efficient capital market theory are that (1) security prices adjust rapidly and in an *unbiased* manner to any new information, and (2) price changes behave in a random manner." Daniel R. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 3 n.9 (1978) (emphasis added).

information they can dig up, they are still missing whatever private information corporate insiders have access to. This means that these investors are at an informational disadvantage relative to corporate insiders when evaluating or even knowing the entire opportunity set of wealth-enhancing investment options available to the corporation. Therefore, the locus of authority in the best position to evaluate stock market signals and maximize shareholder wealth has access to the company's confidential information as well as fiduciary duties to serve the best interests of the company and its shareholders. That locus of authority is the independent Board.

D. Stock Market Signals and the Independent Board

Stock market signals have never been more valuable than in today's world of corporate governance. This is because of the rise of the independent Board. According to Professor Jeffrey Gordon, the typical corporate Board of a public company has transitioned from being comprised of a minority of independent directors to one that is dominated by them, allowing for a dramatic shift in Board focus from managerialism, i.e., the goals of management, to shareholder wealth maximization.[93] Gordon attributes this shift in focus to the theory that independent directors, unlike the insiders and interested outsiders who dominated corporate Boards in the 1950s, "are less committed to management and its vision."[94] Most importantly, "they look to outside performance signals," such as information provided by the stock market, to assess the firm's performance.[95] Professor Gordon also notes that enhanced SEC disclosure

[93] Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1540 (2007). Professor Gordon reports that from 1950 to 2005 the percentage of independent directors serving on the typical Board of a public company has increased from twenty-two to seventy-four percent. *Id.* at 1565 tbl.1.

[94] *Id.* at 1563.

[95] *Id.*

requirements and more transparent accounting standards have facilitated this focus.[96] These factors allow stock prices to reflect corporate information once known only to insiders; thus, stock prices are now much better indicators of company performance.[97] According to Professor Gordon, "[t]he overriding effect is to commit the firm to a shareholder wealth-maximizing strategy as best measured by stock price performance."[98] In sum, the independent Board of a public company is currently in a good position to rationally and even-handedly respond to stock market signals in order to correct managerial inefficiencies and enhance long-term value.

E. The Board as Arbitrator

Given an adequate level of independence, the Board of a public company can view executive management not simply as an extension of itself and vice-versa, but as a locus of authority for corporate decision-making, which it must monitor on an objective basis. It also allows the Board to recognize other parts of the organization, if only on a temporary basis, as competing loci of authority with executive management when they are perceived to add value to the company's decision-making. According to Arrow, decision-making "[e]rror is unnecessary when the information is available somewhere in the organization but not available to or not used by the authority."[99] In the context of the public company, the activist hedge fund may serve as a competing locus of authority and "corrective mechanism" in the decision-making of a large organization.[100]

When an independent Board, the centralized authority in a public company, delegates the bulk of its decision-making to executive management, it is the decision-making of this

96 *Id.* at 1543.

97 *Id.* at 1541, 1543.

98 *Id.* at 1563.

99 KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 74 (1974).

100 *See id.* at 74–75.

locus of authority that is likely to become the focus of criticism by a corrective mechanism such as an activist hedge fund. Empirical evidence shows that within two years of an activist hedge fund gaining representation on a target's Board, the CEO resigns thirty percent of the time.[101] Moreover, the probability of the CEO's eventual departure likely increases if the company is sold, which occurs within five years of an activist hedge fund gaining representation twenty-one percent of the time.[102]

Critically, it is up to the Board to determine which of these two loci of authority, the executive management or activist hedge fund, has the best advice for moving the company forward.[103] Playing the role of arbitrator puts the Board in a difficult position. It must determine who has the best advice for long-term value creation under the following potential conditions: an executive management team that may resist the activist's proposals, no matter how meritorious, simply because of reputational concerns,[104] and an activist that may threaten a proxy contest to obtain Board representation, even if the Board has decided in good faith that the activist's recommendations will not correct managerial inefficiencies. Moreover, even if a Board meets the criteria for independence based on either stock market rules or Delaware corporate law, its decision-making may still be tainted—to a greater or lesser extent—due to "capture" by senior management, making the Board less than perfect in terms of independence.[105] Board of director

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101 Goodwin, *supra* note 1, at 11–12.

102 *Id.*

103 *See* Jonathan B. Cohn & Uday Rajan, *Optimal Corporate Governance in the Presence of an Activist Investor*, 26 REV. FIN. STUD. 985, 985 (2013) (providing "a model of governance in which a board arbitrates between an activist investor and a manager facing reputational concerns"). According to Cohn and Rajan, theirs "is the first theoretical article to consider the interaction between an activist, the board, and a manager." *Id.* at 986.

104 *See id.*

105 Board of director "'capture' occurs when decision-makers such as corporate directors favor certain vested interests such as incumbent management, despite the fact that they purport to be acting in the best

capture results from social norms that may make the Board hesitant to question the decisions of executive management, social ties to its executives, and management control of internal information.[106] Such capture may bias the Board toward favoring internally-presented information over information presented by the stock market to determine which direction the company should take.[107] However, this resistance to information presented by the stock market may be at a low point if the price of the company stock has fallen significantly, an event that does not reflect well on the performance of the Board.

Finally, it may mean that the members of the Board need to recommend the sale of a company at the risk of losing their Board seats. This potential creates yet more bias in their decision-making. Nevertheless, no matter how imperfect the decision-making environment may be, the Board, as the ultimate authority in a public company with the potential to act as an independent and informed arbitrator, and with access to the company's confidential information, is in the best position to decide between the two loci of authority. This process of arbitration should lead to the creation of long-term value at public companies.

interests of some other group, i.e. the shareholders." Jonathan Macey, *Director Capture—A Commentary by Jonathan Macey '82* (Jan. 20, 2009), http://www.law.yale.edu/news/8762.htm [http://perma.cc/7FS6-ZCDD]. *See also* JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 57–61 (2008) (explaining the idea and extent of Board capture). For a good summary of Macey's book, see Jill E. Fisch, *The Overstated Promise of Corporate Governance*, 77 U. CHI. L. REV. 923 (2010) (book review).

106 *See* MACEY, PROMISES KEPT, PROMISES BROKEN, *supra* note 105, at 57–61.

107 *Cf.* Gordon, *supra* note 93, at 1465 (arguing that the increase in the informativeness of stock market prices leads to independent directors being more valuable than insiders, in part because "they look to outside performance signals and are less captured by the internal perspective, which, as stock prices become more informative, becomes less valuable").

F. Summarizing the Integrated Model

The integrated model of corporate governance that the activist hedge fund must deal with and be part of is made up of several different components. First, statutory corporate law provides that the Board is the default locus of authority for the corporation. Second, statutory corporate law also provides that the Board may delegate this authority to the managerial experts, executive management. This locus of authority manages the day-to-day operations of the public company, recommends corporate strategy, and uses its management expertise to implement these strategies. Third, the stock market—through value investors—provides signals to the Board that the decision-making of the Board and, most importantly, executive management may be suffering from inefficiencies. These signals should act as a catalyst, encouraging the Board to enhance its monitoring of executive management. Fourth, the stock market—but this time through the activist hedge fund—provides strategic recommendations for the Board to consider in deciding how the company should move forward. This information can be used by the Board in its monitoring of executive management. Fifth, the Board, assuming an adequate level of independence, can arbitrate between the two loci of authority and then determine which of the following paths it should take: the one recommended by executive management, the one recommended by the activist hedge fund, or perhaps a combination of both.

VI. THE IMPLICATIONS FOR SHAREHOLDER VOTING

As already discussed, the threat of a proxy contest may be the most important weapon the activist hedge fund has in its arsenal to effect change.[108] Yet, actual proxy contests are few in number and the threat of a proxy contest appears to be more important to the activist hedge fund than actually

108 *See* text accompanying notes 32–34.

engaging in one.[109] Nevertheless, Martin Lipton correctly identified shareholder voting in a proxy contest as a negative aspect of hedge fund activism. According to Mr. Lipton, "ISS and major institutional investors will be responsive to and support well-presented attacks on business strategy and operations by activist hedge funds on generally well managed major corporations, even those with an outstanding CEO and board of directors."[110] One interpretation of this statement is that voting for a slate of directors nominated by the activist hedge fund that goes against the recommendations of a well-functioning Board will not be wealth-enhancing. If this interpretation is correct, I am in total agreement with Mr. Lipton's statement.

The problem arises because even if a Board has operated according to the thesis statement—utilizing independent judgment to arbitrate between the advices provided by executive management and the activist hedge fund—the activist may still proceed with a proxy contest. Then, to compound the problem, shareholders and proxy advisory firms may use the wrong criteria in determining how to vote.

But these are not all the issues involved in such a shareholder vote. From an authority model point of view, shareholder voting in a proxy contest is full of risks; the direction of how the company should strategically proceed is placed in the hands of those who generally understand the company the least, the typical institutional investors.[111] Such investors, while sophisticated in many ways and perhaps up-to-date on the latest corporate governance best practices, have hundreds or even thousands of public companies in

109 *Id.*

110 Martin Lipton, *Some Lessons from DuPont-Trian,* HARVARD LAW SCHOOL FORUM ON CORP. GOVERNANCE & FIN. REGULATION (Apr. 30, 2015), http://corpgov.law.harvard.edu/2015/04/30/some-lessons-from-dupont-trian/ [http://perma.cc/S6JD-628A].

111 *See* Gilson & Gordon, *supra* note 47, at 865 (2013) (noting that institutional investors hold over 70% of the outstanding stock of the top thousand U.S. public companies).

their portfolios and each with many matters to vote on.[112] Therefore, they are ill-prepared to participate in the strategic decision-making of any particular company they invest in.

Moreover, institutional investors may utilize index funds as their vehicle for investment, or they may be value investors who know a lot about each company but who do not have the interest or the resources available to become actively involved in such company-centric decision-making.[113] However, instead of simply not voting—a rational response to not being informed or having a lack of interest—institutional investors may either farm out their vote to a proxy advisory service or create internal corporate governance departments to handle proxy voting[114] as a means to meet their federally mandated fiduciary duties.[115]

112 Charles M. Nathan, *The Parallel Universes of Institutional Investing and Institutional Voting*, HARVARD LAW SCHOOL FORUM ON CORP. GOVERNANCE & FIN. REGULATION (Apr. 6, 2010), http://corpgov.law.harvard.edu/2010/04/06/the-parallel-universes-of-institutional-investing-and-institutional-voting/ [http://perma.cc/SE69-9TBA].

113 *See* Gilson & Gordon, *supra* note 47, at 867 (referring to institutional investors who are value investors (earn returns based on fundamental analysis and diversification) and liquidity traders (earn returns through low cost diversification) as "rationally reticent," since they vote, but they do not propose or get involved in trying to influence the management of the corporation); *id.* at 895 (stating that "[i]nstitutional owners who are not seeking private benefits of control are rationally reticent; they also will assign a low value to governance rights since their proactive exercise will not improve the relative performance on which the institutional investor's profitability and ability to attract assets depends" (footnote omitted)).

114 Nathan, *supra* note 112.

115 *See* Department of Labor Interpretive Bulletin Relating to Written Statements of Investment Policy, Including Proxy Voting Policy or Guidelines, 29 C.F.R. § 2509.94-2 (2008) (advising pension funds that proxy voting constituted part of the funds' fiduciary duties to investors); SEC Report of Proxy Voting Record, 17 C.F.R. § 270.30b1-4 (2015) (requiring disclosure of proxy voting by investment companies); SEC Proxy Voting Rule, 17 C.F.R. § 275.206(4)-6 (2015) (requiring investment advisers such as mutual fund companies to "[a]dopt and implement written policies and procedures that are reasonably designed to ensure that [advisers] vote client securities in the best interest of clients").

In either approach, there is a separation between those who make the investment decisions and those who make the voting decisions. Unfortunately, in this situation, the locus of authority in the best position to decide, the independent Board, is relegated to the sidelines as a pitchman for its respective position.[116]

However, the risks of inefficient corporate decision-making resulting from such a proxy contest may be minimized if institutional investors and proxy advisory services understand the value provided by an independent Board. To implement this understanding, shareholders and proxy advisory services must approach voting as a two-step process. First, they must base their votes or recommendations on an evaluation of whether or not they believe the Board is operating with enough competence and independence such that it can act as an efficient arbitrator of the various strategic proposals before it. If yes, then they should vote with the Board and against the nominees of the activist hedge fund. Shareholders should never vote in favor of the activist hedge fund's nominees unless there is clear evidence that the Board lacks competence or independence. To do otherwise would negatively impact the long-term value created by the independent Board when acting in its role of arbitrator.

This approach is analogous to how the business judgment rule is applied in corporate law. That is, when a Board decision is not tainted with a breach of a Board's fiduciary duties, the courts, who are uninformed like the typical investor, will adhere to the business judgment rule and not get involved in the business decision.[117] More importantly, for a typical institutional investor with a diversified portfolio of stocks in its portfolio, this is the only rational approach that can be taken. Utilizing the investment strategy of allowing the locus of authority in the best position to make the decision the opportunity to do so should lead the

116 Rose & Sharfman, *supra* note 2, at 1038.

117 *See supra* note 89 (providing a business judgment rule formulation).

institutional investor to receive the highest returns on its portfolio over time.

The second step comes into play only if there is clear evidence that the Board is not acting competently and/or independently. If so, then and only then should the shareholders and proxy advisory services ask the question, "Have the dissidents made a compelling case that change is warranted?" This is analogous to a court proceeding where the plaintiff is able to overcome the business judgment rule with sufficient evidence of a breach in fiduciary duties, thereby requiring the court to utilize an entire fairness standard of review, fair dealing, and fair price.[118] Hopefully, investors will not be faced with this type of decision very often.

VII. THE RECOMMENDATIONS OF THE ACTIVIST HEDGE FUND

A major criticism of activist hedge funds, and one that allegedly supports the argument that they suffer from short-termism, focuses on the recommendations that they want their target companies to implement. According to Dennis Berman of The Wall Street Journal, "[t]he vast majority [of activist hedge funds] are making similar demands of their targets, delivered with what now feels like a dull percussion: Raise the dividend, buy back shares, cut these costs, spin off that division, sell the company."[119] What these recommendations all have in common is that they are asking companies to target disinvestment, not redirecting or increasing investment. Dennis Berman further writes:

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118 Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) ("If the rule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the 'entire fairness' of the transaction to the shareholder plaintiff.").

119 Dennis K. Berman, *A Radical Idea for Activist Investors: What If the Goal Were More Investment With an Eye on the Long Term?*, WALL ST. J. (Jan. 27, 2015, 9:51 AM), http://www.wsj.com/articles/a-radical-idea-for-activist-investors-1422370260 [http://perma.cc/2UQY-4AVE].

> Here's a drastic question for a field beset by conformity. Why can't activists find targets where the misallocation is going the other way? In other words, identify companies that are playing it too safe, perhaps pushing too much into dividends or buybacks. Or missing a great opportunity in a new market.[120]

Dr. Ralph Walkling summarized Berman's criticism by stating: "Wouldn't we expect a similar pressure by activists encouraging at least some firms to invest more? Shouldn't we expect at least some activists [sic] campaigns to push firms to be less conservative, to invest more, to pursue heretofore missed opportunities?"[121] However, going the other way and advocating for long-term investment "just doesn't happen."[122]

This focus on disinvestment seems at odds with what we know about valuation. The process of valuing a company's stock is the same for activist hedge funds as it is for value investors. Both types of investors will estimate the company's expected cash flows out into the future, and then utilize a discount rate to come up with a present value. Both will use a long-term time horizon to do this calculation, regardless of their expected holding period. Therefore, both types of investors will want the Board and executive management to make the most efficient and shareholder-wealth-enhancing decision—whether it be short-term cost cutting or investing in a long-term project—in order to

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120 *Id.*

121 Ralph A. Walkling, *One Sided Activism? A Note on the Symmetry of Market Problems and the Asymmetries of Activists*, MERGERPROF (Jan. 29, 2015), http://www.mergerprof.com/2015/01/one-sided-activism-note-on-symmetry-of.html [http://perma.cc/7EP9-RHML] (emphasis omitted).

122 Berman, *supra* note 119.

> Consider the database kept by FactSet, which has tracked 3,774 activist campaigns since 2005, and has placed each in one of five categories. There is no such category for "advocating more long-term investment," says FactSet vice president John Laide. "It's an extremely rare demand, so we don't code for it."

Id.

maximize the current value of the stock price.[123] That is, we should expect activist hedge funds to be indifferent to the types of recommendations they make as long as they believe the recommendations will result in the highest possible stock price. If so, then why has it been observed that the recommendations of activist hedge funds seem to be so heavily biased in the direction of disinvestment?

Berman was not the first to observe that activist hedge funds appear to have this bias. According to Marcel Kahan and Ed Rock:

> Activist hedge funds are agents of change with specific goals that depend on the particular company. When the company is diversified, hedge funds often push for divestitures. When it is underperforming, they often push for the sale of the company or a change in management. When the company has excess cash on hand, they push for stock repurchases or dividends. When the company has assets on its balance sheet that can be monetized (e.g., real estate), they push to monetize those assets. When companies are pursuing capital-intensive investment plans, hedge funds sometimes oppose the plans and push for the cash to be returned to shareholders.[124]

Kahan and Rock also offer a possible justification for this approach: "Is it always the case that, when a hedge fund gets involved, it is pushing for business strategies with a short-term payoff over strategies with a more valuable long-term payoff? Or is the short-term payoff preferred by hedge funds sometimes the more valuable one?"[125]

123 *See* Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 532–33 (2002) ("Under elementary principles of finance, even short-term investors have an incentive to maximize the firm's long-term value, because only by doing so can they maximize the price at which long-term investors will buy the shares that short-term investors will soon want to sell (the unity of long-term and short-term shareholder interests is known as Fisher separation).").

124 Kahan & Rock, *supra* note 10, at 1087.

125 *Id.* at 1088.

Perhaps the short-term payoff is the more valuable one. As already discussed, management needs to evaluate all profitable opportunities, no matter what the investment horizon, and then pick those opportunities that have the expectation of maximizing the present value of the company's cash flows in order to have the best chance of achieving long-term value creation. This premise should apply equally to the activist hedge fund. If a hedge fund argues for short-term cost cutting at a company, then this should mean that it expects the recommendation to help achieve long-term value creation and shareholder wealth maximization. For example, an activist hedge fund may recommend that the company's budget for research and development be cut in order for the company to better focus on innovation output in terms of patents and patent citations per research dollar spent.[126] This recommendation would be in keeping with the general mission of a for-profit corporation. In that regard, Alon Brav, Wei Jiang, Song Ma, and Xuan Tian have empirically demonstrated that hedge fund activism targeting a reduction in basic research leads to

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126 Alon Brav et al., *Shareholder Power and Corporate Innovation: Evidence from Hedge Fund Activism* (Kelley Sch. of Bus,, Research Paper No. 2014-05, 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2409404 [http://perma.cc/ZY5R-EGMP] (finding a link between improvements in innovation efficiency and hedge fund activism at firms with a diverse set of patents as a result of the activism leading to a more targeted approach to innovation). According to Brav et al.:

> The improvement in innovation is not uniform across target firms. It is driven by firms that prior to the intervention had a diverse set of patents but after the arrival of activists choose to refocus, leading to an increase in patents and more citations per patent. The increase in innovation is concentrated in technological areas that are central to the core capabilities of the target firms. This set of results constitutes preliminary evidence that firms tend to improve innovation efficiency in the period following intervention.

Id. at 4.

a more focused and efficient approach to innovation,[127] a requirement for long-term value creation.

However, we still do not have an explanation for why there is such an absence of recommendations that involve long-term investment. I propose two interrelated explanations for the dearth of these types of recommendations: first, the cognitive limitations and skill sets of those individuals who participate as activist hedge funds, and second, and more importantly, the limitations of what stock market signals can tell us about company performance and how that drives both the type of individuals who participate in hedge fund activism and what recommendations are made by activist hedge funds.

A. Cognitive Limitations

Activist hedge funds are very possibly better at spotting opportunities for disinvestment than long-term investment. According to Walkling:

> Activists are not by nature, build it, type individuals. Also, the expertise it takes to recognize *over investment* is likely to be more plentiful than the type of expertise it takes to *build something*. I'm not saying one of these skills is more valuable than the other, just that it is not surprising that activists don't possess these skills.[128]

The limited skill set of hedge fund activists should not be surprising. This is a result of the limited types of institutions that can participate in hedge fund activism relative to the market for corporate control. For example, competitors will not participate because they will not want to help the competition without gaining control of the target. Vendors and customers will not participate because this will harm the relationship they have with the target entity. Competitors, customers, and vendors are the types of entities that employ personnel with true insights into the operations of the target

127 *Id.*

128 Walkling, *supra* note 121 (emphasis added).

company and who could make value-added recommendations with regard to reinvigorating product lines, expanding output, making new investments in plant and equipment, etc. Without these types of entities participating in offensive shareholder activism, what you have left are the financial engineers employed by hedge funds.

If true, then this is not necessarily a bad thing in terms of recommendations, only a limiting one. If activists only have expertise in financial restructuring, then we should hope that their recommendations are confined to the financial arena and not in such areas as directing the company into a new area of basic research or product development. Moreover, as comfort to those who oppose hedge fund activism, it would also seem to reduce the opportunities for such activism as opportunities for financial restructuring may not be present at all companies with managerial inefficiencies. Most importantly, it is not necessary that activist hedge funds provide the best recommendations for moving a company forward, only that the recommendations move the company closer to maximizing the net present value of a company's net cash flows (long-term value creation) relative to where it stands today. In sum, even if activist hedge funds are limited to making recommendations only in the financial sphere, they still can be of benefit to public company decision-making.

B. The Limitations of Stock Market Signals

The stock market signals provided by value investors voting with their feet inform the market that managerial inefficiencies may exist at a public company. This does not reflect well on current management. In Henry Manne's world of corporate control, this would mean that the company is ripe for a takeover so that current management can be replaced.[129] In the world of shareholder activism, such signals create a similar message, a presumption that either current management needs to be replaced, or at the very least given less responsibility in terms of managing company

[129] *See* Manne, *supra* note 52, at 112–13.

assets. That is, value investors are telling the rest of the stock market that a particular public company is ripe for disinvestment. They are not providing specifics, only general signals that disinvestment should occur based on the information that it has on hand. These are the kind of signals and information that activist hedge funds are responding to when buying significant amounts of company stock and then making their recommendations for change. Therefore, it is not surprising that the recommendations of activist hedge funds will focus on trying to reduce the amount of assets under current management.

If value investors are signaling that current management should be handling fewer assets, not more, then it is up to current management to make its case to the independent Board that this is not true. The Board then must make a determination of who is right. If the Board determines that the value investors are correct, then the Board can take the appropriate action. For example, the Board may prepare the company for sale so a new management team can raise the level of company productivity, spin off subsidiaries or divisions, increase the cash dividend, enter into stock buybacks to reduce excess cash holdings, reduce basic research, etc. All would be ways of accomplishing the task of reducing assets under current management. Such recommendations are indeed the specialty of financial engineers, and correctly so.

C. The Board's Response to Recommendations

The recommendations provided by the activist hedge fund are based on the foundation provided by value investors voting with their feet, signaling the market of managerial inefficiencies at a public company, and causing a stock price decline. However, the signals provided by value investors will typically lack specificity.[130] By contrast, the

[130] *See* Jeffrey N. Gordon, *The Shaping Force of Corporate Law in the New Economic Order*, 31 U. RICH. L. REV. 1473, 1486 (1997) ("Stock prices are indeed imperfect signals, noisy both because of private information withheld from markets for competitive reasons and because of market

recommendations provided by the activist hedge fund are much more specific, helping the Board in its monitoring of executive management. Moreover, the recommendations provided by the activist hedge fund, even if they exclusively target financial restructuring, help the Board frame its discussion with executive management in regard to reviewing the company's current strategies for long-term value creation and whether or not a change is warranted. This has to be a help to the Board in its quest for long-term value creation.

VIII. CONCLUSION

Though most information traders will vote with their feet when suspected managerial efficiencies exist, leading to a falling stock price, not all information traders will remain passive as a public company's stock price falls. Activist hedge funds see this as an opportunity to make a significant investment in the company when the price is relatively low, and then try to influence the Board to make changes that will increase the price of the company's shares. In essence, the activities of the activist hedge fund provide a second wave of stock market signals that do not just simply reinforce the first, but also put pressure on the Board to correct managerial inefficiencies without taking over the company. If the Board has an adequate amount of independence, it can then arbitrate between executive management and the activist hedge fund to see which path the company should take, allowing the company to proceed on a decision-making process that ends with long-term value creation.

Moreover, the Board is clearly in the best position to decide who is right. The Board has the advantage of basing its recommendations not only on public information, such as the signals provided by value investors that managerial inefficiencies exist, but also on the confidential information internal to the corporation. This is a decision-making

volatility that may result from the flaws in the way markets (and market participants) assess information.").

advantage that only the Board has and, of course, provides significant support for its role as the ultimate locus of authority in determining which path the company should go down.

Finally, there has never been a better time for corporate governance to take advantage of the independent Board. According to Jeffrey Gordon, the independent Board is part of a new corporate governance paradigm that includes a Board focus on shareholder wealth maximization and the use of stock prices as signals of company performance.[131] As part of this paradigm, the Board must act on efficiency grounds to make sure the company has the best chance of achieving long-term value creation:

> Although this new paradigm is bound up with the use of stock market signals in the monitoring of managers, including the evaluation of management's strategic choices, it also opens up space for a distinctive role for the independent board: deciding when prevailing prices misvalue the firm and its strategies. In light of imperfectly efficient capital markets, such a role may be efficiency-based rather than an ineradicable residue of agency costs. For a particular firm, a disfavored strategy may in fact maximize shareholder value over a reasonable time horizon. If the market got it wrong, rejecting its signals may lead to putting the firm's assets to highest and best use. But the most significant efficiency gains (or losses) are systematic: idiosyncratic decisions of an independent board may keep a particular subsector of the economy from converging too rapidly on today's conventional wisdom.[132]

Activist hedge funds make recommendations based on stock market signals provided by value investors. However, the stock market may be wrong. It is up to the independent Board to decide, and in the process of doing so allow the

131 Gordon, *The Rise of Independent Directors*, *supra* note 93, at 1563.
132 *Id.*

activities of the activist hedge fund to help create long-term value.

Finally, it is hoped that this Article will help eliminate the misunderstanding that hedge fund activism threatens the authority model of corporate governance, changing the debate from denying its value, to how it can be best incorporated into the decision-making of a public company.