The Journal of Business, Entrepreneurship & the Law

Volume 11 | Issue 2 Article 5

4-15-2018

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Alon Brav

J.B. Heaton

Jonathan Zandberg

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ALON BRAV,[*] J.B. HEATON,[**] AND JONATHAN ZANDBERG[***]

ABSTRACT

The Brokaw Act was proposed legislation aimed at "financial abuses being carried out by activist hedge funds who promote short-term gains at the expense of long-term growth . . . ." Sponsoring Senators named it after a small town in Wisconsin that, according to the Act's sponsors, was decimated by the actions of a hedge fund activist in shutting down the local paper mill with a loss of hundreds of jobs. The Brokaw Act represented the first attempt at federal legislation aimed at restricting hedge fund activism. Since then, new and similar bipartisan proposals have appeared as have threats of state regulation. In this Comment, we show that the occurrences in Brokaw, Wisconsin are far different from the representations the sponsoring Senators made. Hedge fund activists played essentially

[*] Robert L. Dickens Professor, Duke University Fuqua School of Business and National Bureau of Economic Research. brav@duke.edu.

[**] J.B. Heaton, P.C. jb@jbheaton.com.

[***] Jonathan Zandberg, Ph.D. candidate (Finance), Boston College. zandberg@bc.edu.

For helpful comments and suggestions, we thank Manuel Adelino, Nick Gantchev, Rahul Gupta, Thomas Keusch, Brett Lockard, Jonathan Mishkin, Suresh Nallareddy, Aselia Urmanbetova, and Mark Wilde.

no role in the closure of the Brokaw mill. To the contrary, the paper company's incumbent management closed the mill—just the latest in a series of management's mill closures—amid an industry-wide decline that made the mill uneconomic to keep open. We then consider two claims of hedge fund activism's opponents that appear to motivate the Brokaw Act. The first claim—that hedge fund activists typically use the ten-day disclosure period of Rule 13d-1 to accumulate positions significantly in excess of 5%—has been the subject of empirical study and is incorrect. The second claim—that hedge fund activists often form a "wolf pack" in the pre-disclosure period to act collectively against a target—is also without support from empirical evidence. Neither claim warrants legislative action. Finally, we consider two additional parts of the Brokaw Act. The first would expand the concept of beneficial ownership to include certain derivatives linked to the value of equity securities, while the second would require increased disclosure of short positions in the stock of public companies. Neither activity plays an important role in hedge fund activism, and both require additional study before the passage of any legislation.

I. INTRODUCTION

Most evidence to date supports the proposition that shareholders benefit from the actions of hedge fund activists.[1] Nevertheless, hedge fund activism is unpopular in many quarters, particularly among management and directors that become its targets, but also with some similarly-minded opponents in the academy and business. While hedge fund activism's opponents acknowledge (as they must, given the evidence) that activism is on average associated with stock price increases at target firms,[2] they tend (notwithstanding evidence to the contrary)[3] to characterize that average price increase as a short-run effect that merely reflects a

[1] *See, e.g.*, Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1155 (2015) (concluding that the evidence establishes that hedge fund activism is "followed by long-term improvements, rather than declines, in performance"); Alon Brav, Wei Jiang & Hyunseob Kim, *The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Labor Outcomes*, 28 REV. FIN, STUD. 2723, 2769 (2015) (finding that hedge fund activism improves firm productivity); Alon Brav, Wei Jiang, Song Ma & Xuan Tian, *How Does Hedge Fund Activism Reshape Corporate Innovation?* J. FIN. ECON. (forthcoming), https://papers.ssrn.com/sol3/ papers .cfm?abstract_id=2409404 (finding that firms targeted by activist investors generate more patents that are of higher quality relative to a matched sample. Activists push firms to allocate internal innovation to key areas of expertise and inventors at target firms become more productive relative to those at matched firms).

[2] *See, e.g.*, John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 551 (2016) ("All studies have found that activist campaigns result, *on average*, in short-term gains for shareholders . . . .") (emphasis in original).

[3] *See, e.g.*, Bebchuk, *et al*., *supra* note 1, at 1123 (finding that the short-run price increases that occur at the announcement of activist campaigns do not reverse over the long term).

higher probability of takeover or stock-popping restructuring events.[4] In turn, they attribute little or no social or long-run value to hedge fund activism.

In addition, some critics of hedge fund activism assert that activism results in decreased investment at target firms and, correspondingly, larger payouts to shareholders.[5] While some have interpreted this as evidence that activism stops wasteful overinvestment,[6] hedge fund activism's opponents—implicitly assuming that most existing corporate investment is both in the interests of shareholders and socially valuable—point to reductions in corporate investment as evidence that hedge fund activism sacrifices long-term corporate and social gains for short-term shareholder returns.[7]

Until recently, hedge fund activism's opponents did nothing to target legislation against hedge fund activists, focusing mainly on public debate and requests to the Securities and Exchange Commission—largely ignored to date—for changes in rules that would hinder activist investments. In the words of a leading commentator,

> [u]nlike the hostile takeover, activism has precipitated no significant changes in corporate law. Where the hostile takeover triggered structural changes in state corporate codes and the federal securities laws along with a root and branch reconfiguration of fiduciary duty, hedge fund activism largely leaves corporate law where it found it.[8]

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[4] *See, e.g.*, Coffee & Palia, supra note 2, at 551.

The positive abnormal stock returns on which proponents of hedge fund activism rely do not necessarily demonstrate true gains in efficiency, but may only indicate that the market has given the target firm a higher expected takeover premium; that difference is important because not only may this temporary increase later erode if no takeover results, but in any event it does not demonstrate a true efficiency gain.

Id.

The evidence is to the contrary, however. *See, e.g.*, Nicole M. Boyson, Nickolay Gantchev & Anil Shivdasani, *Activism Mergers*, J. FIN. ECON. (forthcoming), https://papers.ssrn.com/sol3/papers.cfm ?abstract_id=2677416 (finding that "even when a merger offer is unsuccessful, the offer is associated with an increase in the valuation of the target firm through the implementation of real financial and investment policy changes rather than through revaluation effects."). *Id.*

[5] *See, e.g.*, Bebchuk, *et al*., *supra* note 1, at 1137 (identifying activism campaigns that resulted in decreased capital expenditures and research and development and campaigns that resulted in higher payouts to shareholders).

[6] *See, e.g.*, *id.*, at 1136 ("Thus, opponents of hedge fund activism overlook that reducing cash holdings and investments might actually move companies closer to, rather than away from, the levels that are optimal for the long term."). *Id.*

[7] Coffee & Palia, *supra* note 2, at 552 ("[O]ur primary concern is . . . with the possibility that the increasing rate of hedge fund activism is beginning to compel corporate boards and managements to forego long-term investments (particularly in R&D) in favor of a short-term policy of maximizing shareholder payout in the form of dividends and stock buybacks.") *Id.*

[8] William W. Bratton, *Hedge Fund Activism, Poison Pills, and the Jurisprudential Threat*, *in* THE CORPORATE CONTRACT IN CHANGING TIMES: IS THE LAW KEEPING UP? (Aug. 22, 2016), http://papers. ssrn.com/sol3/papers.cfm?abstract_id=2835610.

That almost changed last year.

This Comment explores the first attempt at federal anti-activist legislation, examining both its motivations and its specific legislative goals. On March 17, 2016, United States Senators Tammy Baldwin (D-WI) and Jeff Merkley (D-OR) introduced the legislation[9] to "increase transparency and strengthen oversight of activist hedge funds."[10] Senators Bernie Sanders (I-VT) and Elizabeth Warren (D-MA) co-sponsored the proposed legislation,[11] which sought to implement four major changes to existing law. First, the legislation would have shortened the disclosure period of Section 13(d) of the Securities Exchange Act for over-5% ownership from ten days to two days.[12] Second, the legislation would have expanded the concept of beneficial ownership to include certain derivatives linked to the value of equity securities.[13] Third, the legislation would have given the Securities and Exchange Commission the right to determine when hedge funds are working together to avoid being characterized as a "group" that must disclose their collective interest in an activist target in the time required under Section 13(d).[14] Fourth, the legislation would have required increased disclosure of short positions in the stock of public companies.[15]

The legislation went nowhere, but in the late summer of 2017, Senator Baldwin (D-WI) and Senator David Perdue (R-GA) re-introduced the Brokaw Act, bipartisan "legislation to increase transparency and strengthen oversight of predatory activist hedge funds."[16] The re-introduced legislation would decrease the 13(d) period from ten days to four days,[17] up from the earlier proposal. It would "[p]rotect businesses from hedge fund 'wolf packs' by identifying these coordinated groups of hedge funds as a single group to require disclosure," essentially aiming at the same group disclosures as earlier,[18] and it would, as earlier, "[r]equire derivative disclosure to prevent activist investors from profiting by secretly voting against the company's interests."[19] More recently, Senator Baldwin

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[9] Brokaw Act, S. 2720, 114th Cong. (2016).

[10] Press Release, U.S. Senators Tammy Baldwin and Jeff Merkley Introduce Legislation to Strengthen Oversight of Activist Hedge Funds (Mar. 17, 2016), https://www.baldwin.senate.gov/press-releases/brokaw-act (hereinafter "Press Release"); *see also* Donna Borak and David Benoit, *Democrats Take Aim at Activist Investors*, WALL STREET J. (Mar. 17, 2016), http://www.wsj.com /articles/demo crats-take-aim-at-activist-investors-1458251491.

[11] Press Release, *supra* note 10.

[12] S. 2720, § 2(a).

[13] *Id.* at § 2(b).

[14] *Id.*

[15] *Id.* at § 2(c).

[16] *U.S. Senators Tammy Baldwin and Jeff Merkley Introduce Legislation to Strengthen Oversight of Activists Hedge Funds*, TAMMY BALDWIN (Mar. 17, 2016), https://www.baldwin.senate.gov/press-releases/brokaw-act.

[17] *Id.*

[18] *Id.*

[19] *Id.*

put a hold on two nominees for the U.S. Securities and Exchange Commission,[20] essentially pressuring the two to take positions on executive pay and share buybacks advocated by hedge fund activists.

The Brokaw Act, and Senator Baldwin's advocacy and intervention in the appointment of an SEC Commissioner, are stern warnings of policy divorced from evidence. The purpose of this Comment is to demonstrate just how poorly supported the Brokaw Act was, given the claims of its supporters.

II. THE PROPOSED BROKAW ACT

The Brokaw Act, according to its sponsors,

> is named for a small Wisconsin town that went bankrupt after an out-of-state hedge fund closed a paper mill that had provided good jobs to the town for over 100 years. The activist hedge fund bought up the legendary Wausau Paper Company, forced out its executives and demanded short-term returns like buybacks at the expense of the company's long-term future . . . What happened in Wisconsin is one example of a larger problem that demands action.[21]

The Senators used tough language in attacking hedge fund activists, promising that the Brokaw Act would "help ensure that no other small towns in America will fall victim to activist hedge funds on Wall Street.[22]

In this section, we first explore what happened in Brokaw, Wisconsin, the offered inspiration for the proposed anti-activist legislation. Contrary to the claim that a hedge fund "forced out" executives and "closed a paper mill," we uncover that it was Wausau's incumbent management that closed the mill. The mill closure occurred during a wide downtrend in the domestic paper industry, and, consistent with those wider industry trends, Wausau Paper Corp. had shuttered other mills long before a hedge fund activist arrived on the scene. Recognizing the tremendous misfortune of the lost jobs and the impact on the Brokaw community, it is inaccurate to lay that outcome at the feet of a hedge fund activist. Instead, to address the root cause of these adverse events requires that one first acknowledge the broader trends in competition, regulation, the shift from printed media to electronic communication, and other factors that have led to the decline of this once successful industry and to the long-term implications for the communities that this industry once supported.

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[20] *U.S. Senate OKs two U.S. Securities and Exchange Commission nominees*, REUTERS (Dec. 22, 2017, 12:22 PM), https://www.cnbc.com/2017/12/22/reuters-america-u-s-senate-oks-two-u-s-securities-and-exchange-commission-nominees.html.

[21] Press Release, *supra* note 10.

[22] *Id.*

A. *Wausau's Previous Mill Closures*

A brief review of broad industry trends is helpful. The top panel in Figure 1 provides the total number of employees in the paper and paper products industry over the period 1990–2015.[23] Shaded areas mark National Bureau of Economic Research (NBER) recessions and the red line marks China's membership in the World Trade Organization.[24] There is a striking decline in the number of employees in this industry. Slightly more than 40% of jobs in the industry were lost over the sample period. Most of the decline took place from the late 1990s through 2010, with a somewhat lower decline thereafter.

It is well known that the United States has been losing manufacturing jobs over the same time period. In an effort to disentangle the decline in employment in the paper and paper products from these broader trends, we provide a simple decomposition of the decline into that driven by overall employment trends in the United States and, more specifically, in manufacturing. The second panel in Figure 1 provides the ratio of employment in manufacturing to total nonfarm U.S. employment, showing the large decline in manufacturing relative to total nonfarm employment. Employment in manufacturing comprised approximately 16% of total nonfarm employment in the early 1990s, declining to about 9% by 2015.

[23] Bureau of Labor Statistics, http://www.bls.gov/data/\#employment (last visited May 26, 2018). Employment data used in Figure 1 is from the U.S. Bureau of Labor Statistics Data Retrieval Tools. Paper and paper products industry is based on NAICS code 322. The employment data is not seasonally adjusted.

[24] China became a member of the World Trade Organization on December 11, 2001. *Id.*

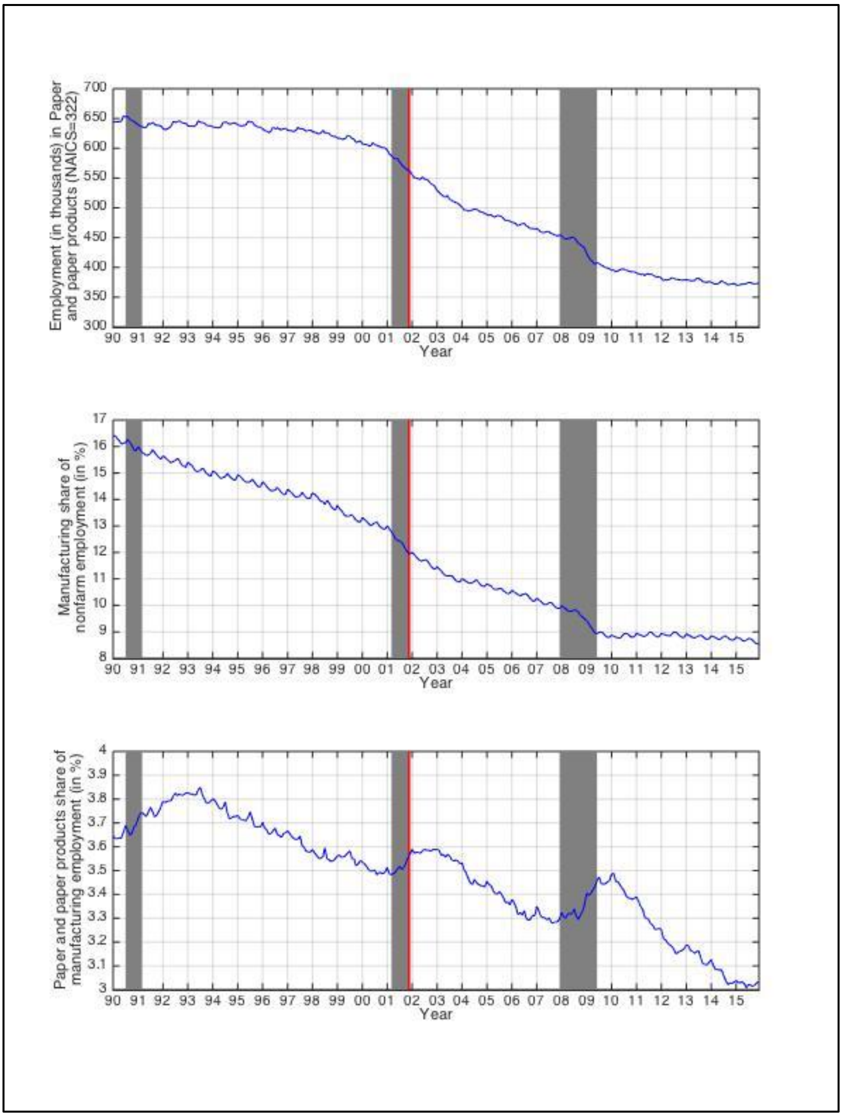

Figure 1: Employment Trends in the Paper and Paper Products Industry

Importantly, in the third panel we provide the ratio of employment in paper and paper products to that of employment in manufacturing. If the decline in employment in paper and paper products mirrored that in manufacturing, we would expect to see a constant share throughout the twenty-five-year period. Instead, we see a rate of decline in the paper and paper products industry that has been even greater than for manufacturing generally. Paper and paper products comprised about 3.7% of employment in manufacturing in the early 1990s and then showed a persistent decline throughout, reaching about 3% by 2015.[25] Overall, Figure 1 presents a bleak set of data, demonstrating how badly employment has turned down in the U.S. paper and paper products industry even relative to the decline in manufacturing.

The decline in employment can be traced to several economic factors: first, the decline in demand due to substitution away from print paper as a means of communication and advertising to alternative electronic platforms. Second, heightened foreign competition, predominantly from China, that had negative effects on overall manufacturing employment in the United States.[26] Third, increased concern about the environment led to more stringent regulation resulting in costly investments to meet heightened standards to mitigate pollution. Consistent with these declines, the number of pulp and paper mills has been falling for years.[27] The Alliance for American Manufacturing reports on a study from the Center for Paper Business and Industry Studies at Georgia Tech University finding that "since 2000, approximately 126 paper mills in the U.S. have ceased operations and 223,000 well-paid Americans have lost their jobs."[28] The decline of the paper and paper products industry unquestionably has been devastating for jobs and communities.[29]

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[25] *See* Patrick McCarthy & Aselia Urmanbetova, *Pulp and Paper Economic Indicators: A Comparative Analysis*, CENTER FOR PAPER BUS. & INDUSTRY STUD. (September 2015) (reporting similar evidence on employment trends in the paper industry and in two sub-sectors: pulp, paper, and paperboard mills and the converted products sector.). "Between 1990 and 2010, employment in the pulp, paper, and paperboard mills sub-sector fell by more than 50%" and "[t]he employment loss in the converted paper products sector was a bit more but the percentage loss was less at 30% over the entire period . . ." *Id*.

[26] David H. Autor, David Dorn & Gordon H. Hanson, *The China Syndrome: Local Labor Market Effects of Import Competition in the United States*, 103 AM. ECON. REV. 2121 (2013) ("[E]xposure to Chinese import competition affects local labor markets not just through manufacturing employment, which unsurprisingly is adversely affected, but also along numerous other margins. Import shocks trigger a decline in wages that is primarily observed outside of the manufacturing sector. Reductions in both employment and wage levels lead to a steep drop in the average earnings of households.") *Id.*

[27] Maija Hujala, Heli Arminen, R. Carter Hill & Kaisu Puumalainen, *Explaining the Shifts of International Trade in Pulp and Paper Industry*, 59 FOREST SCI. 211 (2013) ("In the traditional paper production areas, i.e., North America and Western Europe, paper demand is stagnating or even decreasing, depending on the paper grade, and, as a consequence, the number of pulp and paper machines and mills has declined dramatically in recent years."). *Id.*

[28] The decline in the number of paper mills traces further back to the 1970s. Changyou Sun, *Lifetimes of US Paper and Allied Products Mills: Insights from a Duration Analysis*, 30 J. APPLIED FORESTRY 5, (2006) ("Nationwide, there were 577 mills in 1970 but only 499 in 2000") (internal citation omitted); Jeffrey Bonior, *Picking Up The Pieces After A Paper Mill Closes*, ALL. FOR AM. MFG. (May 14, 2015), http://www.americanmanufacturing.org/blog/entry/picking-up-the-pieces-after-paper-mill-closes.

[29] For a study of the impact of a mill closure on a rural Canadian town, see Jacquelyn Mary Oncescu, *Rural Restructuring: Community Stakeholders' Perspectives of the Impact of a Pulp and Paper Mill Closure on Community Relationships*, 24 RURAL SOC'Y 177 (2015).

Given the long-term decline in the paper and paper products industry, it is no surprise that the Wausau Paper Corp.—the owner of the Brokaw mill—was closing mills for years with no involvement from shareholder activists. In 2005, the company closed its sulfite pulp mill in Brokaw, Wisconsin—the same town that ten years later saw the closure of its paper mill and gave the Brokaw Act its name. The company blamed the 2005 closure on the pulp mill's "high cost of operations and capital investment requirements related to the unit's aging plant and equipment," with the shutdown affecting sixty permanent jobs.[30] In 2007, the company closed its Groveton, New Hampshire mill at a cost of approximately 303 jobs, blaming declining profitability in that mill's division on "secular decline in the demand for" the mill's products "and chronically oversupplied markets in North America," among other things.[31] In December 2008, the company announced the closure of its Appleton, Wisconsin facility, with a cost of ninety jobs.[32] In March 2009, the company announced the closure of its Livermore Falls/Jay, Maine mill, saying that the closure (along with other decisions announced by the company) were "necessary to . . . match capacity with demand during a period of severe economic difficulty."[33] That mill closure cost ninety-six jobs.[34] All these closures took place well before the arrival of a hedge fund activist, Starboard Value, in mid-2011.

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[30] *Wausau Paper Announces Pulp Mill Closure*, BUS. WIRE (July 6, 2005, 5:22 PM), https://www.businesswire.com/news/home/20050706005869/en/Wausau-Paper-Announces-Pulp-Mill-Closure.

[31] For the announcement of the closure, see Press Release, SEC, Wausau Paper Announces Third-Quarter Results (Oct. 23, 2007), https://www.sec.gov/Archives/edgar/data/105076/0000916480 0 7000142/wpex991.htm. The village of Groveton is located within the town limits on Northumberland. *Northumberland*, NEXTDOOR, https://nextdoor.com/neighborhood/northumberland--groveton--nh/ (last visited Apr. 5, 2018). This town experienced the closure of another paper mill in 2007, the Groveton Paper Board mill, leading to the loss of 108 workers. For a report analyzing these closures and "the devastating economic impact on this area from the closure of those two mills," see Letter from Richard S. Brothers, NHES Commissioner (Dec. 2007), http://www.nhes.nh.gov/elmi/products/documents /cooscounty-groveton.pdf. As of early 2016 the town had not been successful in bringing back lost jobs. *See Town approves $400K bond to bring jobs to former mill site*, CONCORD MONITOR (Mar. 14, 2016), http://www.concordmonitor.com/Articles/2016/03/From-Archives1/GrovetonMill-cm-031516.

[32] Press Release, SEC, Wausau Paper Revises Fourth-Quarter Earnings Guidance Reflecting Weaker Market Conditions (Dec. 17, 2008), https://www.sec.gov/Archives/edgar/data/105076/0000 91648008000170/wpex99.htm.

[33] Press Release, SEC, Wausau Paper Announces Strategic Financial & Capacity Initiatives (Mar. 31, 2009), https://www.sec.gov/Archives/egar/data/105076/000091648009000079/wpex991.htm.

[34] The company shut down one paper machine earlier in the year at this mill so the combined loss totaled 235 mill workers. *See* Bobbie Hanstein, *Wausau Paper announces permanent shut down of Livermore Falls/ Jay Mill*, DAILY BULLDOG (Apr. 1, 2009), http://www.dailybulldog/com/db/features/ wausau-paper-announces-permanent-shut-down-of-livermore-fallsjay-mill/.

B. The Brokaw Mill Closure

Did "an out-of-state hedge fund close[] a paper mill that had provided good jobs to the town for over 100 years" after "[forcing] out its executives"?[35] A look at the timeline and the public announcements proves the answer is no. Though engaged in some discussions with a hedge fund activist at the time of the Brokaw mill closure, Wausau's existing board of directors and executives remained in full control of the company before and during the decision to close the Brokaw mill in December 2011 and had been considering closure of the Brokaw mill for months and possibly years.

Evidence of the decline in the company's paper segment can be traced to well before the arrival of the activist investor in mid-2011. The company stated in its 2007 annual report that it initiated a profit recovery plan and noted its "determination to address the underperforming portions of [its] business. In [its] most challenging segment, Printing & Writing . . ."—the segment including the Brokaw mill. The report refers to the continued decline over the entire decade in the demand for uncoated free sheet paper resulting in "paper supply [that] has exceeded demand despite the consolidation and capacity rationalization which has occurred across the industry. These factors have led to highly competitive market conditions and eroding industry margins with pricing leverage insufficient to offset the impact of increased manufacturing costs—most notably fiber and energy."[36] "The same report links the decision to close the Groveton mill (303 lost jobs) to the company's three-part recovery plan, which the company completed in the fourth quarter of 2009."[37]

The company's effort to grow its towel and tissue segment, while stemming the loss in the paper division, are well summarized by the October 3, 2010 Deutsche Bank report summarizing the company's third quarter results:

> The Big Picture. Focus on tissue (good margins, good returns), consider monetization of land ($1+/share) & exit paper business. 2009 claim to have "fixed" paper doesn't hold up. WPP continues to plow time & cash into paper despite a decade of woeful performance (reinvest in Rhinelander upgrade, Buy Brainerd mill, shut Groveton & Jay mills, reinvest in Brokaw mill, put $27MM more into Brainerd, etc.). Value & options around paper are steadily shrinking. We like & respect mgmt. [sic], but with executive comp equaling large %

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[35] Press Release, *supra* note 10.

[36] *Change is Inevitable Progress, Essential*, WAUSAU PAPER, (2007), http://www.annualreports.com/HostedData/AnnualReportArchive/w/NYSE_WPP_2007.pdf.

[37] Alon Brav, J.B. Heaton, and Jonathan Zandberg, *Failed Anti-Activist Legislation: The Curious Case of the Brokaw Act*, SSRN (Feb. 9, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2860167.

> of GAAP net income for several yrs [sic], are their incentives aligned with public shareholders.[38]

This 2010 report is telling for three reasons. First, it reiterates the need to focus on the successful segment of the company—towel and tissue—which, a year later, the hedge fund activist will adopt as the main part of its restructuring efforts. Second, the report objects to the company's claim that the recovery plan has fixed the trouble in the paper segment. Third, the analysts question whether the high executive compensation is set optimally to incentivize management. Six months later, on April 11, 2011, Deutsche Bank followed with an additional report stating: "Despite claims of having 'fixed' these operations 2yrs [sic] ago, the numbers suggest otherwise. Even so, Wausau continues to plow additional capital into the specialty mills."[39] The analysts continue to stress their concern with executive compensation stating that "it's not clear management incentives are aligned with those of shareholders."[40]

We plot in Figure 2 the annual total of CEO compensation from 2000 through 2014.[41] The sample reflects the tenure of three CEOs.[42] The first, from 2000–2011, the second from 2012–2013, and the last one for 2014.[43] The level of compensation increases throughout the decade, peaking in 2011, the same year in which the company decided to shut down the Brokaw mill.[44] This pattern is consistent with the analyst's concerns regarding the dysfunctional link between bad firm performance and high executive compensation.[45]

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[38] *Id.*

[39] *Id.*

[40] *Id.*

[41] *Id.* Executive compensation data is from Execucomp, a subscription-based database. We use their total compensation measure, TDC1, defined as the sum of salary, bonus, other annual, restricted stock grants, LTIP Payouts, all other, and Execucomp's own methodology of estimating the fair value of option grants. For recent papers that use TDC1, *see* Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?* 123 Q.J. ECON. (February 2008), and Steven N. Kaplan & Joshua Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?* 23 REV. FIN. STUD. 1004 (2010) ("TDC1 will more closely approximate the compensation a company's board expected to pay the executive.") Execucomp also provides the total compensation as reported by the company to the SEC for 2006–2014. These figures are qualitatively similar to those provides in Figure 2. For example, in 2006 the company reported a total compensation for the CEO of $2.2M, rising to $4.7M in 2009, $4.5M in 2010, and then declining to $1.5M in 2013 and $0.6M in 2014.

[42] Alon Brav, J.B. Heaton, and Jonathan Zandberg, *Failed Anti-Activist Legislation: The Curious Case of the Brokaw Act*, SSRN (Feb. 9, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2860167.

[43] *Id.*

[44] *Id.*

[45] Id.

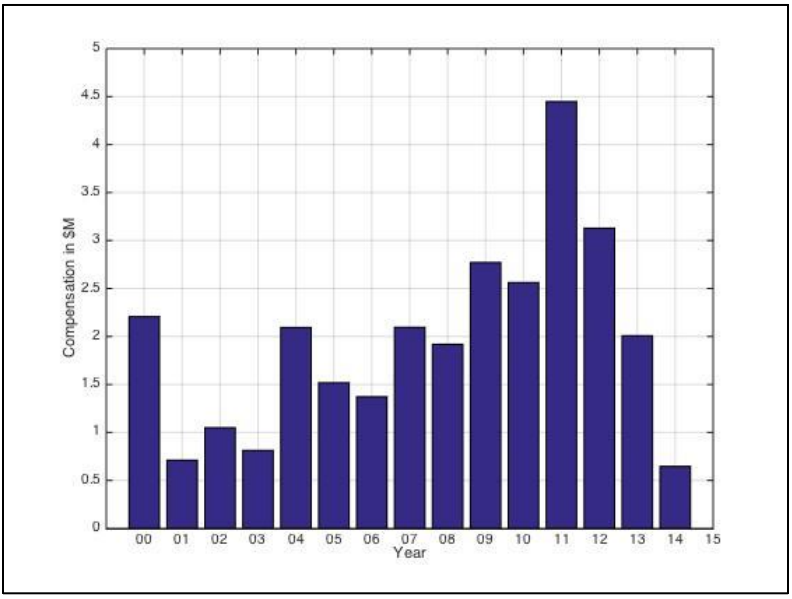

Figure 2: CEO Compensation at Wausau Paper

In the months before the announcement of the Brokaw mill closure, Wausau Paper Corp. was in discussions with a well-known hedge fund activist, Starboard Value. We know from publicly-available materials that Wausau's senior management met privately with representatives of Starboard Value on June 20, 2011.[46] On July 28, 2011, Starboard Value filed a Schedule 13D[47] reporting ownership of 6.3% of the common stock of Wausau.[48] In a letter dated July 28, 2011, the principal of Starboard Value, Jeffrey C. Smith, wrote to Wausau's then-chief executive officer that Wausau was "deeply undervalued," partly as a result of the effect the "dismal performance of the Company's paper business" was having on the company's more successful tissue business.[49] The paper business, Smith argued, was "struggling due to increased commoditization and significant competition

[46] *Starboard Delivers Letter to CEO and Board of Directors of Wausau Paper*, PR NEWSWIRE (Oct. 3, 2011), http://www.prnewswire.com/news-releases/starboard-delivers-letter-to-ceo-and-board-of-directors-of-wausau-paper-130980908.html (displaying letter from Jeffrey C. Smith, Managing Member, Starboard Value LP, to Thomas J. Howatt, President and CEO, Wausau Paper Corp. from July 28, 2011).

[47] Section 13(d) of the Securities Exchange Act of 1934 requires those who acquire more than 5 percent of the stock of a public company to file a Schedule 13D within ten days. 15 U.S.C. § 78m(d)(1) (2016).

[48] *Schedule 13D Information,* United States SEC (July 18, 2011), https://www.sec.gov/Archives/edgar/data/105076/000092189511001506/sc13d06297097_07182011.htm.

[49] PR NEWS WIRE, *supra* note 46.

from larger and more established players."[50] By contrast, Smith wrote Wausau's tissue business had a "bright future."[51] Overall, Starboard's observations appear to mirror the views of outside analysts and Wausau's own management.

Just three days later, the local paper reported a story about the Brokaw mill. "According to an internal Wausau Paper Corp. memo from the vice president to the employees dated July 12, 2011, the Brokaw mill had failed to earn acceptable returns for Wausau since 2002."[52] "While the Brokaw mill has a proud manufacturing tradition that dates back over 100 years, we are facing an unprecedented perfect storm of rising input costs, declining demand and ever more aggressive competitors," the company management wrote.[53] The company's spokesman, who verified the authenticity of the memo, referred to the Brokaw mill as "our most challenged facility."[54] Wausau later said that it had "been evaluating strategic alternatives for the Paper segment's print and color business[—the part of Wausau's business that included the Brokaw mill—]since the first quarter of 2011 and ha[d] engaged a financial advisor in continuing to evaluate a range of alternatives."[55] All this suggests that possible closure of the Brokaw mill had been on the table for months, if not years, before the arrival of the activist.

The clearest indication of Starboard Value's assessment regarding the future of the Brokaw mill—an assessment that advocated a sale, not closure—was made public in a letter sent on October 3, 2011 to the CEO and board of directors of the company:

> [W]e believe the Board must be proactive and hire a financial advisor to immediately explore a sale of this business to one of several larger and better capitalized strategic acquirers. Such potential acquirers would be well positioned to realize substantial synergies by merging the Paper business with their own operations.[56]

By December 2011, however, the company had decided not only to shut down the Brokaw mill, but also to exit the print and color paper business entirely, attributing the decision to "dramatic and irreversible market demand decline and

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[50] *Id*.
[51] *Id*.
[52] Alon Brav, J.B. Heaton, and Jonathan Zandberg, *Failed Anti-Activist Legislation: The Curious Case of the Brokaw Act*, SSRN (Feb. 9, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2860167.
[53] *Id.*
[54] *Id.*
[55] *Form 8-K: Current Report*, United States SEC (Oct. 19, 2011), https://www.sec.gov/Archives/edgar/data/ 105076/000091648011000132/wp8k.htm.
[56] PR NEWS WIRE, *supra* note 46.

the need for consolidation to bring these markets properly into balance."[57] On December 6, 2011, the Wausau board of directors approved a plan to permanently close the Brokaw mill.[58] In doing so, the company eliminated approximately 450 hourly and salaried jobs.[59] There is no evidence that hedge fund activism played any determinative role in the closure of the Brokaw mill.[60]

Then, where did the story come from? Years after the closure, Wausau's chief executive officer claimed that Wausau had a buyer lined up for the Brokaw mill, but that Starboard Value's public criticism of the paper business caused the potential buyer to lower its price to an "unacceptable" level around the same time that the mill lost a major customer.[61] He did not disclose the "unacceptable" terms, but it is difficult to believe that Starboard Value's criticism of the paper industry could have influenced a potential mill buyer, where those criticisms reflected well-known and overwhelming industry trends.[62] More likely, the story reflects after-the-fact scapegoating, a story that—while apparently false—motivates legislation proposed in the United States Senate.[63]

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[57] *Wausau Paper Enters Agreement to Sell Premium Print & Color Brands*, United States SEC (Dec. 7, 2011), https://www.sec.gov/Archives/edgar/data/105076/000091648011000149/wpex99.htm

[58] *Form 8-K: Current Report*, United States SEC (Dec. 7, 2011), https://www.sec.gov/Archives/edgar/data/105076/000091648011000149/wp8k.htm.

[59] *Id.*

[60] Alon Brav, J.B. Heaton, Jonathan Zandberg, *Failed Anti-Activist Legislation: The Curious Case of the Brokaw Act*, SSRN (Feb. 8, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2860167. Starboard Value's block ownership at the end of December 2011 was 8.458% based on their 13F filing to the SEC and obtained from S&P Capital IQ. At the same time, other long-term, typically passive institutions, held jointly a much larger fraction of the company stock. Specifically, the top ten were, BlackRock (10.06%), Wilmington (5.984%), Dimensional Fund Advisors (5.624%), Wells Capital Management (5.528%), T. Rowe Price (5.222%), Vanguard (5.195%), DePrince, Race & Zollo (3.754), Brookfield Asset Management (2.927%), Columbia Management Investment Advisers (2.912%), Credit Suisse Asset Management (2.359%), for a combined 49.565% of shares outstanding. Capital IQ also provides shares ownership by current and previous company insiders. The top five at the end of December 2011 were: San W. Orr, Jr., who at the time was the non-executive chairman of the board (4.094%), Gary Freels, a former director, (1.983%), Thomas Howatt, the CEO of the company since August 2000 (0.593%), Andrew Baur, a former director (0.224%), and Hank Newell, who at the time was executive vice president and chief operating officer and about to replace Howatt as CEO in January 2012 (0.084%). *Id.*

[61] Michael Kranish, *Rise of Activist Investing Is Felt at Century-Old Firm*, BOSTON GLOBE (Aug. 15, 2015), https://www.bostonglobe.com/news/nation/2015/08/15/the-rise-activist-investing-felt-century-old-company/TgtMxLrZGbuUyWSsgFtCEP/story.html.

[62] *Id.* Starboard Value continued its discussions with Wausau management through the fall of 2011, but never approached control of the company. On October 3, 2011, Starboard Value filed an amended Schedule 13D disclosing ownership of 7.5% of the common stock of Wausau. *Schedule 13D*, SEC (Sept. 29, 2011), https://www.sec.gov/Archives/edgar/data/105076/000092189511001889/sc13da106297097_09292011.htm.

[63] *See* Kranish, *supra* note 61.

III. TWO QUESTIONABLE CLAIMS ABOUT HEDGE FUND ACTIVISM

We now consider two claims inherent in the Brokaw Act. The first—that hedge fund activists typically use the ten-day disclosure period of Rule 13(d)-(1) to accumulate positions significantly in excess of 5%—has been the subject of empirical study and has been disproven.[64] The second—that hedge fund activists often form a "wolf pack" in the pre-disclosure period to act collectively against a target—is also without empirical support.[65]

A. *Myth: Activists "Abuse" the Schedule 13D Disclosure Window*

The Brokaw Act would have shortened the disclosure period of Section 13(d) of the Securities Exchange Act for 5% ownership to two days.[66] Currently, Section 13(d) of the Securities Exchange Act and Rule 13(d)-1(a) require that any beneficial owner of more than 5% of a class of registered equity securities must file Schedule 13D within ten days after passing the 5% threshold.[67] Schedule 13D discloses the identity of the beneficial owner, the funding source for the purchases, the investment purposes, the number of shares, and other information.[68] Some commentators have argued that trading volume in advance of Schedule 13D disclosures is so high that it must reflect wolf pack formation. Professors Coffee and Palia examine a chart showing an increase in abnormal volume and conclude

> that the high volume of trading that is evident . . . on the last eight days preceding the Schedule 13D's filing is attributable to others, who most likely have been informed by those filing the Schedule 13D of their intentions. The inference then seems obvious: tipping and informed trading appears to characterize both the formation of the 'wolf pack' and transactions during the window period preceding the filing of the Schedule 13D.[69]

But, there are serious problems with this inference. Professors Coffee and Palia made their inference after examining a chart that appears to show an increase in abnormal volume starting at day t-8 (i.e., eight days before the Schedule 13D filing). That chart is reproduced below in Figure 3 below. Professors Coffee and Palia cite to evidence that "most of the buying by those who file a Schedule 13D

[64] Brokaw Act, 115 S. 1744 (2017).
[65] *Id.*
[66] *Id.*
[67] 17 C.F.R. § 240. 13d-1(a).
[68] *Id.*
[69] Coffee and Palia, *supra* note 2, at 565. These claims have largely been accepted at face value. *See, e.g.*, William R. Tevlin, *The Conscious Parallelism of Wolf Packs: Applying the Antitrust Conspiracy Framework to Section 13(d) Activist Group Formation*, 84 FORDHAM L. REV. 2335 (2016), http://ir.lawnet.fordham.edu/flr/vol84/iss5/17.

is 'concentrated on the day they cross the threshold as well as the following day.'"[70] They then *assume*, without evidence, that the day of and day after the threshold is crossed are days t-10 and t-9 from the filing date so that, in their reasoning, the observed abnormal volume apparent from days t-8 to the filing date of the Schedule 13D "is attributable to others" than the hedge fund activist.[71] They then claim that those "others . . . most likely have been informed by those filing the Schedule 13D of their intentions."[72] They assert, "[t]hus, much of the buying during the ten-day window seems likely to be by other wolf pack members."[73]

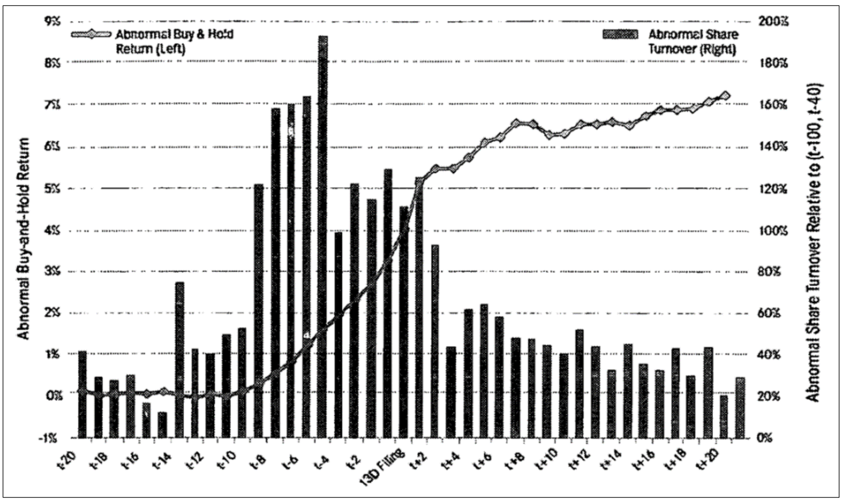

Figure 3: Event Day Return and Turnover (Coffee and Palia)

The problem is that it is factually incorrect to assume that hedge fund activists cross the 5% threshold on days t-10 and t-9, such that the trading in the remaining eight days is by others. Hedge fund activists often file Schedule 13Ds well before the ten-day window closes. The histogram in Figure 4, reproduced from prior work,[74] shows that many hedge fund activists file before the ten-day window closes with a large number of filings in the days before day ten.

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[70] Coffee and Palia, *supra* note 2, at 565 (quoting Bebchuk, et al., *supra* note 1, at 6).
[71] *Id.* at 565.
[72] *Id.*
[73] *Id.*
[74] Bebchuk, et al. *supra* note 1, at 4–5 fig.1.

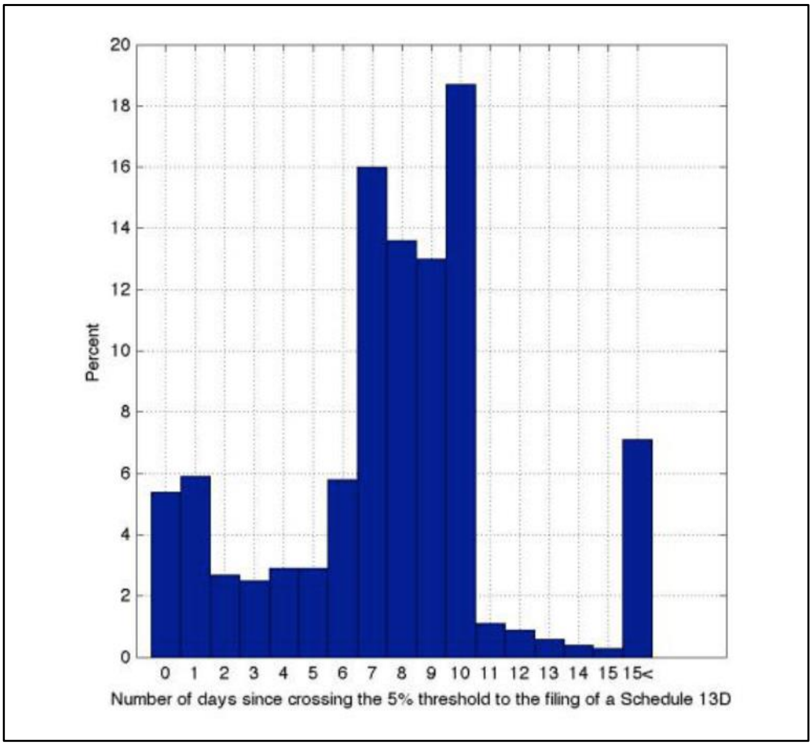

Figure 4: Distribution of Number of Days from Crossing to Filing Date

If Professors Coffee and Palia want to determine the level of abnormal volume following the date that the activist crosses the 5% threshold, they must center data on the date the reporting threshold was crossed rather than the date that the Schedule 13D was filed. When we do so, the anomalous pattern of abnormal volume disappears; volume spikes on the day the activist crosses, with much smaller levels of abnormal volume before that date, as reflected in Figure 5, a reproduced chart from an earlier study:[75]

[75] *Id.* at 23. Corroborating evidence is given in Nickolay Gantchev & Pab Jotikasthira, *Institutional Trading and Hedge Fund Activism*, MGMT. SCI., (Feb. 23, 2017), https://pubsonline.informs.org/doi/abs/10.1287/mnsc.2016.2654 (tracking hedge fund ownership for a sample of events over the period 2000–2007). The majority of the activist stake is purchased in the days leading to and including the date in which the activist crosses the five-percent threshold. *See id.* figs.1 & 2.

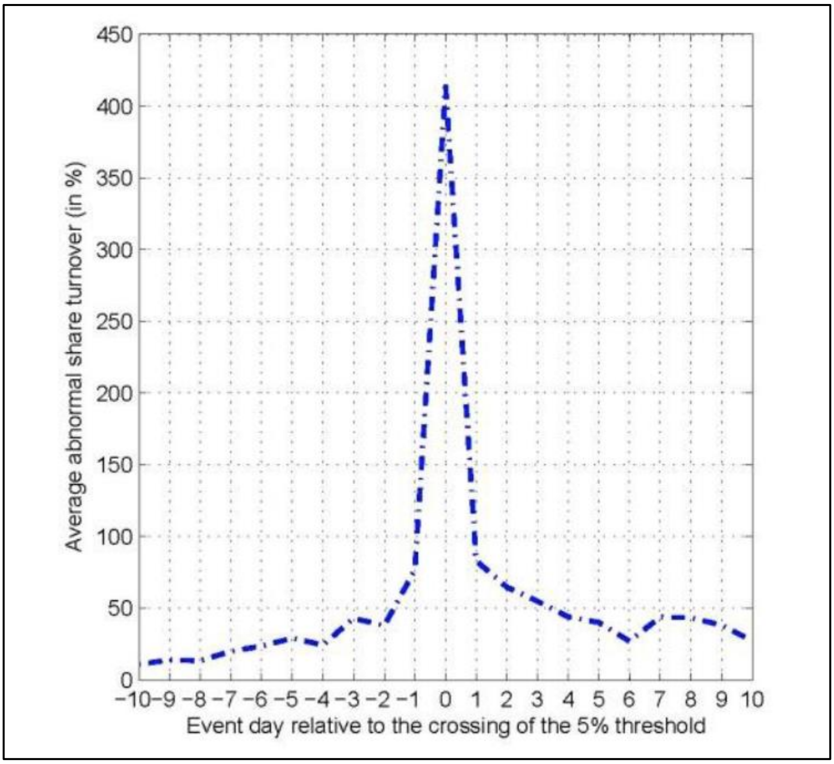

Figure 5: Turnover Centered Around the Crossing of the 5% Threshold

Figures 4 and 5 show that (i) there is a large variation in the number of days that activists take in order to publicly file and (ii) that the exceptional trading volume, if any, occurs on the day the activist crosses the 5% threshold. If one erroneously assumes that activists always take ten days until filing, then an event study centered on the filing date (rather than the cross date) would lead one to the mistaken conclusion (such as that by Coffee and Palia) that abnormal trading took place several days after the crossing.

Note that the data does not eliminate the possibility of some tipping or wolf pack formation after the crossing of the 5% threshold, but as Figure 5 illustrates, the number of additional shares purchased by the elusive pack is economically small and is nowhere near the range suggested by Coffee and Palia unless much of the trading on the trigger date is by investors forming a wolf pack. It is also likely that an important part of the trading on the threshold day is by investors other than the hedge fund activist. Such trading can arise either because of leaked information about the activist's intent to cross the 5% threshold or because activists *choose to trade* precisely when they anticipate or observe uninformed selling.

While leakage of information is possible, we are not aware of any direct empirical evidence supporting such a large-scale sharing of information. This is especially important since similar patterns of abnormal volume—with a spike at the threshold crossing date—appear for non-activist Schedule 13D filers as well where no plausible "wolf pack" theory exists.[76] Second, trading by hedge fund activists is not independent of abnormal volume. Research shows that hedge fund activists trade more—i.e., build their positions—when liquidity (i.e., volume) is higher.[77] That is, the high turnover is what one should expect to see if Schedule 13D filers, whether activists or not, choose to trade.[78] There simply is no basis to assume that trading by non-activists is trading by members of a wolf pack.

IV. TWO OTHER BROKAW ACT PROPOSALS AND THE MYTHS BEHIND THEM

We now consider two additional parts of the proposed Brokaw Act. The first would have expanded the concept of beneficial ownership to include certain derivatives linked to the value of equity securities. The second would have required increased disclosure of short positions in the stock of public companies. Neither activity plays any important role in hedge fund activism.

A. Expanding the Definition of Beneficial Ownership

The Brokaw Act would have expanded the concept of beneficial ownership to include derivatives linked to the value of equity securities that currently do not have to be reported.[79] Under existing rules, beneficial ownership occurs when a person, directly or indirectly, has the power (or the right to acquire such power) to vote or dispose of an equity security. The real target of the Brokaw Act is cash-settled swaps. Cash-settled swaps that reference common stock give their "long" counterparty the right to receive the value of any increase in the price of the underlying shares plus the value of any cash distributions, like dividends.[80] Cash-

[76] *See* Ulf von Lilienfeld-Toal & Jan Schnitzler, *What is Special About Hedge Fund Activism?: Evidence from 13-D Filings* (Swedish House of Finance Research Paper No. 14–16, 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2506704. Von Lilienfeld-Toal and Schnitzler collect a sample of all Schedule 13D filings between 1985–2012, splitting their sample into filings made by hedge funds, financial institutions, insiders and other 10% holders and other unidentified filers. *Id.* As can be seen from their Figure 9, the spike in turnover and the steep subsequent decline in turnover is evident in all four subsamples. *Id.* at fig.9.

[77] Pierre Collin-Dufresne and Vyacheslav Fos, *Do Prices Reveal the Presence of Informed Trading?* 70 J. FIN. 1555 (2015) (activists select times of higher liquidity when they trade); Atanas Mihov, *Predisclosure Accumulations by Activist Investors and Price Impact of Trading*, REV. FIN. 231 (2016).

[78] Nickolay Gantchev and Pab Jotikasthira, *Institutional Trading and Hedge Fund Activism*, MGMT. SCI. (forthcoming 2016) (linking institutional selling in the period prior to the Schedule 13D filing, which they argue to be uninformed, to activists' supply of liquidity and block formation).

[79] S. 2720, § 2(b).

[80] *See generally* Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, S. CAL. L. REV. 811 (2006).

settled swaps obligate their long counterparty to pay to the "short" counterparty the value of any decline in the value of the shares plus interest.[81] Typically, the short counterparty—usually a swap dealer such as a broker-dealer—purchases actual shares of the underlying stock to hedge the risk of price increases and dividend payments that it faces by maintaining a short position in the cash-settled swap.[82] As a result, the cash-settled swap—which might otherwise be viewed as a purely economic instrument without control rights over securities—can result in the control of stock by the cash-settled swap counterparty (via its hedge) that may either give the long counterparty some influence over the voting of the shares or create the possibility of a quick acquisition of the shares in settlement of the derivative.[83]

Beyond a single well-publicized case, however,[84] there is little evidence of the extent to which cash-settled swaps are important in hedge fund activism. To the extent that they are used to evade the reporting requirements of Section 13(d), existing law already requires treating the underlying share interest as beneficially owned.[85] Existing law also already requires the reporting of exchange-traded options positions that are settled physically, though recent research shows that activists rarely use such options.[86] Moreover, it is not clear that the desire that some investors and issuers may have for a full picture of an activist's economic interest should outweigh an activist's interest in keeping private that part of its investment that does not directly or indirectly influence voting control of the issuer's securities.[87] It may be true, as a leading jurist and commentator suggests, that "there is good reason to make sure that the other stockholders have full information about the precise economic interests" of an activist.[88] But that case remains to be made.

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[81] *Id.*

[82] *Id.*

[83] *Id.*

[84] *See* CSX Corp. v. Children's Inv. Fund Mgt. (UK) LLP, 562 F. Supp. 2d 511, 518 (S.D.N.Y. 2008); J.B. Heaton, *CSX Corporation v. The Children's Investment Fund: Total Return Swaps as Evasions of Section 13(d) Reporting*, SEC. LIT. J. 16 (Summer 2009).

[85] Heaton, *supra* note 85, at 16–17.

[86] Pierre Collin-Dufresne, Vyacheslav Fos & Dmitry Muravyev, *Informed Trading and Option Prices: Evidence from Activist Trading* 4 (Swiss Finance Institute Research Paper No. 15–55, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2675866 ("We find that informed investors rarely use derivatives. Specifically, only in 66 out of 2,905 Schedule 13D filings we analyze do informed investors disclose the usage of derivatives"). *Id.*

[87] *Id.* at 7.

[88] 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, 473 (2014).

B. Requiring Disclosure of Short Positions

The Brokaw Act would have required disclosure within two business days of short interest representing more than 5% of an issuer's equity securities, essentially mirroring the requirements for long positions.[89] Short sellers sell borrowed shares at a price they believe will be higher than the price they will be required to pay in the future to return the shares to the share lender.[90] A "short sale" is "any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller."[91] It is (in this context) a bet on the decline in the share price. Financial economics has long suggested that some short selling may be necessary to prevent prices from reflecting only the views of the most optimistic investors in the market.[92] Research demonstrates that short sellers also play an important role in uncovering firms that misrepresent their financial statements.[93] Unlike long positions, neither Section 13(d) nor any other U.S. securities regulation requires investors to disclose short positions in excess of some threshold percentage.

The sponsoring Senators asserted that "[d]erivatives are part of every activist's toolkit. In some cases, they are used to create a 'net short' that allows the activist to profit by secretly voting against the company's interests."[94] This was a strange claim in context of the Brokaw Act. Short positions play essentially no role in hedge fund activism of the type that otherwise appears to be the target of the legislation, i.e., investment positions that the activist hopes will increase in value as the stock of the target increases. Instead, the Brokaw Act's proposal for short positions may have been aimed only at a unique situation where a hedge fund buys shares giving it voting power, but hedges out its economic interest with short positions, a phenomenon known as "empty voting."[95] In any case, the proposal was never likely to do much. The staff of the Division of Economic and Risk Analysis of the U.S. Securities and Exchange Commission has reported that short positions of 5% or more are "extremely rare."[96]

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[89] Chris Gyves, Darryl R. Marsch & Jessica L. Dickerson, *Beneficial Ownership Reporting and the Brokaw Act*, WOMBLE CARLYLE (Apr. 8, 2016), https://www.lexology.com/library/document.ashx?g=7b5fee58-4030-4a7e-b2de-5bf8c84ec209.

[90] Tomi Kilgore, *Short Sellers are not Evil, but They are Misunderstood*, MARKET WATCH (Nov. 13, 2017), https://www.marketwatch.com/story/short-sellers-are-not-evil-but-they-are-misunderstood-2017-11-08.

[91] 17 C.F.R. § 242.200(a) (2016).

[92] *Short Sale Position and Transaction Reporting*, SEC (June 5, 2014), https://www.sec.gov/dera/reportspubs/special-studies/short-sale-position-and-transaction-reporting.pdf [hereinafter Staff Report].

[93] Jonathan M. Karpoff & Xiaoxia Lou, *Short Sellers and Financial Misconduct*, 65 J. FIN. 1879 (2010); *see also* Wuyang Zhao, Activist Short-Selling (Oct. 19, 2016) (unpublished Ph.D. dissertation, University of Toronto), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2852041.

[94] Baldwin, *supra* note 16.

[95] *See, e.g.*, Henry T.C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, Reforms*, 61 BUS. LAW. 1011 (2006).

[96] Staff Report, *supra* note 92, at 93.

V. CONCLUSION

When bad things happen, it is tempting to conclude that something must be done. But the loss of jobs in Brokaw, Wisconsin was not the work of hedge fund activists, and nothing that happened there warrants anti-activist legislation. The Brokaw Act targets hedge fund activists for conduct that is largely mythical rather than addressing the root cause of the loss in jobs in the paper industry that has been caused by changes in demand, competition, regulation, and other factors that have led to the decline of this once great industry.

We must be on guard against policies as poorly supported as the Brokaw Act. Publicly-held corporations produce much of the world's products and services, employ a good part of the world's population, directly and indirectly, and are the means through which much of the world's investable wealth is created and held. Hedge fund activists are merely the latest incarnation of an activity that has been present since the first shares of a corporation were dispersed beyond the corporation's directors and managers: scrutiny of director and manager decision making by non-director, non-manager shareholders. Hedge fund activists spend considerable time and resources to identify companies that might become more valuable (that is, have higher share prices) through some change of action by managers. Activist investors employ highly-skilled analysts and use available information to form proposals for change at target companies. Importantly, activist investors put money where their mouths are, buying stakes that are significant enough to pay back the expenses of investigating targets, engaging with management and other shareholders, and, if necessary, engaging in expensive contests for the votes of other shareholders and, sometimes, even litigation. If activist investors are successful (at least partially) in persuading the company's directors or their fellow stockholders to pursue new strategies, they enjoy the financial benefits. If they are wrong, they may incur losses. And many have.

Non-shareholders—especially employees, officers, and directors, and the politicians who represent them—have an interest in a corporation staying alive beyond the time horizon of the initial business opportunity that sparked the corporation's formation in the first place. To the extent that the corporation can raise capital and invest its cash flow in the profitable exploitation of new business opportunities, the share price benefits alongside those with a more tangible interest in the corporation's survival. But it is not a foregone conclusion that longevity is good for shareholders.

Sometimes "exit"—leaving the market and shutting down operations—is the strategy that maximizes shareholder value. As one court put it in a different context, "[a] corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it."[97] Unfortunately, the evidence suggests that officers and directors of public corporations do a poor job of

[97] In re Inv'rs Funding Corp. of N.Y. Sec. Litig., 523 F. Supp. 533, 541 (S.D.N.Y. 1980).

exiting in a timely and efficient fashion. Instead, many corporations continue to invest in businesses that cannot be expected to deliver adequate returns on new investment, while others use good cash flow from existing businesses to "diversify" into new lines, rather than returning those funds to shareholders and letting shareholders invest in new businesses on their own.

Not surprisingly, some hedge fund activism is aimed at stopping value-destroying decisions of this type or reversing such decisions that were made in the past. This puts hedge fund activists—and the shareholders who support them—at odds with those constituencies we mentioned above who benefit from those decisions. And there is no question that what is in the interests of shareholders is often painful for non-shareholders. There is an undeniable human cost to capitalism's "creative destruction"—the term coined by economist Joseph Schumpeter in his classic Capitalism, Socialism and Democracy[98]—including the pain of unemployment and the psychic sting of perceived failure. There are good reasons to believe that a vibrant capitalist system that facilitates exit and encourages reinvestment is the best form of economic system available in the sense that it is the best way to ensure the maximum amount of wealth in a society. But that is cold comfort to a dislocated worker, an officer or director whose business judgment is no longer bearing fruit, or a community ravaged by the close of its largest employer. Part of understanding hedge fund activism is understanding the real conflict that exists between shareholders and non-shareholders. But that is no excuse for misrepresentations in the law-making process.

[98] JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY (1942).