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Shareholder Activism & Departure from Board Centrism: Beware of Federal Government's Intervention

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SHAREHOLDER ACTIVISM & DEPARTURE FROM BOARD'S CENTRISM: BEWARE OF FEDERAL GOVERNMENT'S INTERVENTION.

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INTRODUCTION

Corporations are one of the main driving forces behind America's economic greatness and our nation's long-term prosperity. The first American corporations were developed in the early 1790s, making these few institutions key players in the young nation's economy.[1] One of the many advantageous features of corporate formation is the ability to pool funds from a wide set of individuals for investment.[2] The inevitable reality of corporations' pooling of funds, however, raises the issue of entrusting the investors' money to a group of people—the board of directors—who represent the shareholders' interests and make sure that the company's management acts on behalf of those shareholders.[3] Not surprisingly, the decisions made by boards of directors are routinely scrutinized by shareholders who seek returns on their investments.[4]

Shareholder activism has emerged as a method to hold boards of directors more accountable to the interests of shareholders, whatever those interests may be.[5] Given the high frequency and success rate of activist campaigns, shareholders pressure boards on a wide variety of issues, such as executive pay, carbon-intensive investments, and social issues.[6] More importantly, shareholder activists and institutional investors—the kind of investors most involved in activism—tend to enjoy significant victories in the legislative process in the aftermath of major economic crises.[7] The unfortunate consequence of these legislative victories is a departure from the concept of "director primacy" and an even greater power delivered into the hands of activists driven by short-term returns. This paper will argue that the next economic downturn—and downturns appear to be cyclical—will prompt

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[1] *What is the History of the Corporations in America?*, INVESTOPEDIA, https://www.investopedia.com/ask/answers/041515/what-history-corporations-america.asp (last updated Aug. 3, 2019).

[2] James Chen, *Pooled Funds*, INVESTOPEDIA, https://www.investopedia.com/terms/p/pooledfunds.asp (last updated Jan. 12, 2020).

[3] Jeanne Grunert & Rachel Siegel, *Board of Directors*, INVESTINGANSWERS, https://investinganswers.com/dictionary/b/board-directors (last updated Oct. 1, 2019).

[4] Michael Eisner & Michael Orvitz, *Directors Face Increased Scrutiny, Need to Stay Well Informed*, SILICON VALLEY BUS. J. (Jan. 8, 2006), https://bizjournals.com/sanjose/stories/2006/01/09/focus3.html.

[5] Warren Staples & Andrew Linden, *Shareholder Activism Might Sound Good, but It's Delusional to Think it Will Change Anything Much*, CONVERSATION: ECON. & BUS., http://theconversation.com/ /shareholder-activism-might-sound-good-but-its-delusional-to-think-it-will-change-anything-much-125807 (last visited Mar. 10, 2020).

[6] *Id.*

[7] STEPHEN BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 122–23 (2012) (explaining that both Sarbanes-Oxley and Dodd-Frank's Acts placed limitations on executive pay, an issue central to many activist attacks). *See also id.*, at 136 (asserting that the say on pay legislation was "strongly supported by institutional investors and their allies, including the Council of Institutional Investors 'Consumer Federation of America, AFSCME, and the Investor's Working Group'").

another federal response in a direction further away from the director primacy.[8] It will also show that the Federal Government's reactive response will continue to reflect the populist anti-board hysteria until the decision-making power in a corporation is substantially divested from the board. Departure from the board's primacy will encourage institutional investors to continue the pursuit of short-term returns—a strategy that often leads to underinvestment in production efficiency or research and technology—while the CEOs of America will continue to get blamed as being the "fat corporate cats" and enemies of the ordinary folk.

I. TERMINOLOGY & BACKGROUND

To dive into the details of the shareholder activism phenomenon, it is prudent to go over the necessary fundamentals of the corporate governance. Corporate governance is the system through which companies are controlled.[9] Within this system, shareholders are responsible for electing a board of directors.[10] The Board makes complex decisions to achieve the purpose of the corporation.[11] According to one of the most crucial case-law principles of corporate law—the Business Judgment Rule—the daily operation of a business is a risky endeavor entailing controversial decisions which can be unprofitable or unpopular.[12] That being said, courts usually refuse to review the substance of the board's decisions, unless the board violates the duty of care or loyalty to the corporation.[13] Since shareholders rarely get a full and extensive opportunity to question the substance of a board's decisions, they

8 Sean Ross, *Are Economic Recessions Inevitable?*, INVESTOPEDIA, https://www.investopedia.com/ask/answers/032015/are-economic-recessions-inevitable.asp (last updated Feb. 6, 2020).

9 *What Is Corporate Governance?*, INST. OF CHARTERED ACCTS. IN ENG. & WALES,https://www.icaew.com/technical/corporate-governance/principles/principles-articles/does-corporate-governance-matter (last visited Mar. 11, 2021).

10 Kelly Mroz, *Who Elects a Company's Board of Directors?*, HOUS. CHRON, https://smallbusiness.chron.com/elects-companys-board-directors-67545.html (last visited Feb. 21, 2020).

11 James Chen, *Board of Directors (B of D)*, INVESTOPEDIA, https://www.investopedia.com/terms/b/boardofdirectors.asp (last updated Sept. 27, 2019).

12 Will Kenton, *Business Judgment Rule*, INVESTOPEDIA, https://www.investopedia.com/terms/b/businessjudgmentrule.asp (last updated Nov. 23, 2019).

13 *THE PROPRIETY OF JUDICIAL DEFERENCE TO CORPORATE BOARD OF DIRECTORS*, 96 HARV. L. REV. 1894 (1983).

attempt to influence the board's decision-making process through the annual election of directors.[14] Shareholders seek to elect individuals that would be receptive towards the desired changes within a corporation.

Shareholder's scrutiny of boards' decisions gave rise to the concept of shareholder activism—which was been hailed and criticized by market participants across the spectrum.[15] "A shareholder activist is a person who . . . use[s] his or her rights as a . . . [shareholder] of a . . . corporation to bring about change within the company."[16] Different classes of shares provide distinct voting privileges, aside from varying dividend-receiving benefits.[17] Minority stakeholders can implement unoffensive methods ranging from a simple dialogue with the board to a formal proposal that can be voted on by all shareholders.[18] More importantly, shareholder activists can launch large-scale campaigns which often attempt to pressure the company and other shareholders through national media coverage.[19] As such, these offensive tactics have a higher chance at mobilizing sufficient shares to effectuate change.[20]

In the last few decades, there has been a rise in shareholder activism. "According to a 2018 report by *Activist Insight*, the number of companies around the globe receiving governance-related proposals from activists has steadily increased, with growth averaging about [eleven percent] for the last four years and campaigns targeting 805 companies worldwide in 2017."[21] The rise of shareholder activism is primarily backed by large institutional

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[14] Sean Ross, *How Do a Corporation's Shareholders Influence its Board of Directors?*, INVESTOPEDIA, https://investopedia.com/ask/answers/072815/how-do-corporations-shareholders-influence-its-board-directors.asp (last updated Feb. 4, 2020).

[15] Glenn Curtis, *Activist Investors: A Good or Bad Thing?*, INVESTOPEDIA, https://investopedia.com/articles/stocks/09/activist-investors.asp (last updated Mar. 19, 2019).

[16] James Chen, *Shareholder Activist*, INVESTOPEDIA, https://www.investopedia.com/terms/s/shareholderactivist.asp (last updated June 25, 2019).

[17] *Id.*

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] Yuliya Ponomareva, *Shareholder Activism Is on the Rise: Caution Required*, FORBES (Dec. 10, 2018), https://www.forbes.com/sites/esade/2018/12/10/shareholder-activism-is-on-the-rise-caution-required/#545524734844.

investors—pension funds, insurance companies, banks, and hedge funds.[22] Notably, institutional activism in the context of a pension fund is different from that of hedge funds or private equity firms.[23] If pension fund activism is typically reactive to an underperforming portfolio of a company, hedge fund activism is proactive—it identifies a firm whose performance could be improved and then investing in it.[24] Hedge funds and private equity funds seek to acquire a sufficient amount of shares to become a majority or plurality shareholder.[25] Sometimes, an acquiring shareholder may be limited by defensive mechanisms installed by the company's board or management—be it poison pills or a staggered board.[26] In that case, the activist shareholder has no choice but to mobilize other shareholders through a corporation-wide campaign.[27]

II. WHY SHOULD THE CORPORATE WORLD AWAIT MORE FEDERAL PRO-ACTIVIST LEGISLATION?

To understand why the federal government tends to come out on the activist side in the aftermath of a financial crisis or major corporate scandals, one must consider the changes that shareholder activists often seek to implement. The most contentious topics for debate advanced by shareholder activists concern are (1) executive pay, (2) underperforming stock price, and (3) other social or political issues.[28] For many years leading up to the stock

[22] Owen Davis, *Can Shareholder Activism Tame the Financial System?*, GLOB. POL'Y J. OP. (Feb. 18, 2019), https://www.globalpolicyjournal.com/blog/18/02/2019/can-shareholder-activism-tame-financial-system.

[23] *Id.*

[24] BAINBRIDGE, *supra* note 7, at 145.

[25] Chen, *supra* note 16.

[26] Barclay Palmer, *Corporate Takeover Defense: A Shareholder's Perspective*, INVESTOPEDIA, https://www.investopedia.com/articles/stocks/08/corporate-takeover-defense.asp (last updated Feb. 12, 2020).

[27] Dominik Breitinger & Sophie Hardach, *Activist Investors Are More Powerful than Ever. Here's What that Means for the Economy*, WORLD ECON. F. (Sept. 5, 2018), https://weforum.org/agenda/2018/09/activist-investors-more-powerful-than-ever-wider-economy/.

[28] Mary Ann Cloyd, *Shareholder Activism: Who, What, When and How?*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Apr. 7, 2015), https://corpgov.law.harvard.edu/2015/04/07/shareholder-activism-who-what-when-and-how/.

market crash of 2008, activists complained that executive and director salaries were unjustifiably inflated.[29] Political campaigns of many influential candidates were furiously vocal towards "outrageous" and "unconscionable" rewards received by leaders of large corporations.[30] Within the context of the 2008 economic crisis, the activist argument was that excessive compensation models of directors and top management officials encouraged excessive risk-taking and led to bad decisions.[31] The executive pay issue is usually pursued by pension funds or labor funds seeking to decrease that compensation.[32]

Another ground for shareholder activism is the effect on "shareholder value."[33] "Shareholder value is the value delivered to the equity owners of a corporation due to management's ability to increase sales, earnings, and free cash flow[s], which leads to an increase in dividends and capital gains for the shareholders."[34] When an activist sees that shareholders of a given corporation are not reaping the benefits of their equity share—even if those benefits are short-term—a hedge fund or a private equity firm can orchestrate a campaign which will be programmed to emphasize the gap between the actual earnings of a corporation and the investor expectations.[35] Activism concerning proposals to increase shareholder value is usually driven by hedge funds or private equity firms.[36]

Consider the actions of shareholder activists in years preceding the financial crisis of 2008, where the Sarbanes-Oxley and Dodd-Frank Acts, which were originally solutions proposed by activists, included regulations of executive pay.[37] For example, the Sarbanes-Oxley Act provided a "clawback provision" which mandated depriving a CEO of any bonus, incentive, or

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[29] BAINBRIDGE, *supra* note 7, at 109.

[30] *Id.*

[31] *Id.* at 119.

[32] *See* Davis, *supra* note 22.

[33] *See* Cloyd, *supra* note 28 (explaining that activist investors "believe that . . . changes may promote more effective corporate governance, and that good governance enhances shareholder value.")

[34] Adam Hayes, *Shareholder Value Definition*, INVESTOPEDIA, https://www.investopedia.com/terms/s/shareholder-value.asp (last updated Aug. 15, 2020).

[35] *See* Chen, *supra* note 16.

[36] *Id.*; Aneliya S. Crawford et al., *Friend or Foe? The Convergence of Private Equity and Shareholder Activism*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 21, 2020), https://corpgov.law.harvard.edu/2020/03/21/friend-or-foe-the-convergence-of-private-equity-and-shareholder-activism/.

[37] BAINBRIDGE, *supra* note 7, at 122–23; *see* The Sarbanes-Oxley Act of 2002 § 304, Pub. L. No. 107-204, 116 Stat. 745 (2002); The Dodd-Frank Act of 2010 § 954, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

equity-based compensation if his or her corporation had to restate financial statements due to “misconduct”.[38] In the eyes of legislators and advocates of the Sarbanes-Oxley Act, excessive compensation encouraged irresponsible risk-taking by directors, which contributed to the 2008 financial crisis.[39] This comment explains that it was not the dollar amount of the compensation but the form of compensation that was the problem. The Sarbanes-Oxley Act imposed performance-based plans which encouraged directors to maximize the short-term returns in any given quarter—a riskier endeavor—without regard to the long-term risks.[40] In that way, the Sarbanes-Oxley Act produced behavior that was contrary to its underlying objective—to encourage responsible bookkeeping and to make the boards more risk-averse.[41]

Another legislation, the Dodd-Frank Wall Street Reform and Consumer Protection Act, introduced the so-called “say on pay” requirement, which requires reporting companies to conduct a shareholder advisory vote on specified executive compensation at least once every three years.[42] Again, similar to the Sarbanes-Oxley Act, the legislators and backers of Dodd-Frank regarded executive pay as a contributor to excessive risk-taking—which contributed to the financial crisis of 2008.[43] In fact, the model of shareholder empowerment prescribed by the Dodd-Frank Act appears to be a failed attempt at a fair—and less “board-centric” way—of determining executive compensation.[44] It turned out that ‘say on pay’ provision, which was strongly supported by large institutional investors and their allies, weakened the “director primacy” in questions of executive compensation and made the board’s compensation even more susceptible towards the short-term interests of institutional investors.[45]

According to the Senate Report drafted during deliberations on The Restoring American Stability Act of 2010, Ms. Ann Yerger, representing the Council of Institutional Investors, wrote in congressional testimony for the committee:

> [T]he Council believes an annual, advisory shareowner vote on executive compensation would efficiently

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[38] BAINBRIDGE, *supra* note 7, at 129–30.
[39] *Id.* at 119.
[40] *Id.* at 123–24.
[41] *Id.* at 136.
[42] *Id.* at 132; *see* The Dodd-Frank Act § 951 (2010).
[43] BAINBRIDGE, *supra* note 7, at 118.
[44] *Id.* at 134–36.
[45] *Id.*

> and effectively provide boards with useful information about whether investors view the company's compensation practices to be in shareowners' best interests. Non-binding shareholder votes on pay would serve as a direct referendum on the decisions of the compensation committee and would offer a more targeted way to signal shareowner discontent that withholding votes from committee members. They might also induce compensation committees to be more careful about doling out rich rewards, to avoid the embarrassment of shareowner rejection at the ballot box. In addition, compensation committees looking to actively rein in executive compensation could use the results of advisory shareowner votes to stand up to excessively demanding officers or compensation consultants.[46]

"Proponents of [']say on pay['] claim it will help make management more accountable, but they ignore the probability that say on pay really will shift power from boards of directors not to shareholders but to advisory firms like RiskMetrics."[47] The Dodd-Frank Act shifted the decision-making power on the issues of executive compensation from one interested group of people, the board of directors, to a different interested group of people, advisory firms.[48] Firstly, the conflicting interests of advisory firms are only constrained by the market itself, because of "the possibility that [advisory firms] will lose credibility and therefore customers."[49] According to proponents of shareholder activism, this market constraint does not work when it comes to holding management accountable—however, having this constraint as an exclusive check on advisory firms who counsel corporations on executive pay is entirely appropriate.[50] The hypocrisy gives no alternative but to conclude that 'say on pay' was a populist outcry of policy entrepreneurs whose agenda was unrelated to fixing corporate governance issues which contributed to the financial crisis.[51]

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[46] *Id.* at 136 n. 90 (quoting The Restoring American Financial Stability Act, S. 111–176 (2010), https://www.congress.gov/congressional-report/111th-congress/senate-report/176/1).

[47] *Id.* at 133.

[48] BAINBRIDGE, *supra* note 7, at 133–34. "The most important proxy advisor, RiskMetrics, already faces conflict issues in its dual role of both advising and rating firms on corporate governance that will be greatly magnified when it begins to rate firms on their compensation plans." *Id.*

[49] *Id.*

[50] *Id.*

[51] *Id.*

Moreover, as shareholder activists famously argue, the 'fat cats' of corporate America get unjustifiably high compensation, become less and less risk averse, and eventually get so careless that they may cause another financial catastrophe.[52] For example, to avoid unjustifiable compensation plans, Dodd-Frank requires "each reporting company's annual proxy statement to contain a clear exposition of the relationship between executive compensation and the issuer's financial performance"—a requirement that is almost impossible to comply with.[53] The Council of Institutional Investors (CII)—the de facto trade association for large activist investors—supported this provision of the Dodd-Frank.[54] Thus, while extremely inefficient and practically unenforceable, the provision merely taps into the public's anger and the increasing gap between ordinary citizens and corporate America.

Another example of inefficient and over-inclusive legislation is the clawback provision under the Sarbanes-Oxley Act. This clawback provision was fueled by the populist momentum in the aftermath of Enron and WorldCom accounting scandals.[55] The clawback provision requires that if a corporation was forced to restate its financial statements due to misconduct, the CEO and CFO must return to the corporation any bonus, incentive, or equity-based compensation they received during the twelve months following the original issuance of restated statements, plus any profits made from the sale of corporate stock during that period.[56] Apart from being virtually unenforceable, this provision caused consequences contrary to what was intended—"companies increased non-forfeitable, fixed-salary compensation and decreased incentive compensation, thereby providing insurance to managers for increased risk."[57]

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[52] *Id.* at 124.

[53] *Id.* at 127. This requirement is going to be very burdensome: [It] means that for every employee, the company would have to calculate his or her salary, bonus, stock awards, option awards, nonequity inventive plan compensation, change in pension value and nonqualified deferred compensation earnings, and all other compensation (e.g., perquisites). This information would undoubtedly be extremely time-consuming to collect and analyze, making it virtually impossible for a company with thousands of employees to comply with this section of the Act. *Id.*

[54] *Id.*

[55] *See* Brian Jebb & Sarah Henchoz, *Why Clawback Provisions Are a Must: Present and Future Risks in Financial Services*, CORP. COMPLIANCE INSIGHTS (Mar. 29, 2019), https://www.corporatecomplianceinsights.com/why-clawback-provisions-are-a-must-present-and-future-risks-in-financial-services/.

[56] BAINBRIDGE, *supra* note 7, at 130.

[57] *Id.* at 132.

All in all, the Dodd-Frank and Sarbanes-Oxley Acts exemplify activist-backed legislation that included unenforceable provisions developed in response to public outcry due to a variety of crises and scandals. This reactionary response led to provisions with unintended consequences under the disguise of punishing the "fat corporate cats." Unfortunately, activists lobby for provisions like 'say on pay,' which in fact takes America even further from board centrism—a principle partially responsible for the greatness of corporate America.

As stated above, shareholder value is a big foothold that activists revolve their campaigns around.[58] In theory, activists are supposed to create value for bidders and the acquired corporation. But is that assertion supported by empirical data? If so, is the value represented by an actual boost in production and not just a short-term spike in stock prices?

Empirical data leans more towards value destruction than value creation for bidders. Companies that were subjected to hostile takeovers tend to display a decline in operating returns, share price, return on equity, earnings growth, earnings stability, and earnings quality.[59] Thus, this comment will argue that value created by shareholder activism, if any, tends to be short term, whereas the hedge funds and private equity firms—who stand behind most of the "shareholder value" activist campaigns—naturally cause the board and corporate managers to focus on an increase of short-term stock prices at the expense of long-term business health. "Doing business that way puts jobs and sustainable industry at risk, now and in the future."[60]

Of course, this comment will not assert that the modern corporate governance system is flawless or that it does not need a natural balancing force which will drive the boards of publicly traded companies to wisely balance the risk, especially in times immediately preceding recession. What this comment will assert, however, is that the shareholder activism phenomenon—as it emerged within the last couple of decades—is not the light at the end of the tunnel.

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[58] *See supra* text accompanying notes 32-33.

[59] B.W.A. Möhlmann, *Hostile Takeovers: The Long-Term Effect on Shareholder Value of Acquiring Companies*, ERASMUS SCH. OF ECON. 44 (2012), https://pdfs.semanticscholar.org/2690/225c8c066f74f23a51cbd05f5f595283f71b.pdf.

[60] BAINBRIDGE, *supra* note 7, at 253.

III. SHAREHOLDER ACTIVISM PHENOMENON AND ITS PLACE IN CORPORATE AMERICA

Shareholder activists have become active in corporate governance.[61] They push for changes in strategy and the adoption of specific business plans.[62] Their tactics include buying shares, conducting public campaigns, lobbying managers and other shareholders, seeking representation on the board of directors, and sometimes running a proxy contest.[63] In response, many boards adopted a variety of "defensive measures," including deploying "poison pill" shareholder rights plans against activists.[64] "As the name indicates, a poison pill is analogous to something that's difficult to swallow or accept. Poison pills . . . significantly raise the cose of acquisitions and create big disincentives to deter such attempts completely."[65] There is a debate as to whether poison pills implemented by a target company are appropriate in any given context.[66] Under the *Unocal* test, judges must determine whether the defense against a hostile bid is "reasonable in relation to the threat" and not motivated primarily out of a desire to effectuate a perpetuation of control.[67] The *Unocal* test consists of two prongs: 1) the directors have shown that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed, and 2) the implemented defense must be reasonable in relation to the threat posed.[68]

In most cases, litigation disputes involving takeover defense strategies were ruled in favor of the target corporation under the business judgment rule.[69] Delaware courts held that directors satisfy the first part of the *Unocal* test by demonstrating good faith and reasonable investigation.[70] Such a standard is relatively easily satisfied by retaining outside financial or legal

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[61] Marcel Kahan & Edward Rock, *Contributions: Anti-Activist Poison Pills*, 99 B.U. L. REV. 915 (2019).
[62] Chen, *supra* note 16.
[63] *Id.*
[64] Adam Hayes, *Poison Pill*, INVESTOPEDIA, https://investopedia.com/terms/p/poisonpill.asp (last updated Sept. 22, 2020).
[65] *Id.*
[66] Dealbook, *Debating the Poison Pill*, N.Y. TIMES (June 16, 2006 5:15 AM), https://www.dealbook.nytimes.com/2006/06/16/debating-the-poison-pill/.
[67] Kahan & Rock, *supra* note 61, at 921.
[68] *Id.*
[69] *Id.* at 922.
[70] *Id.*

counsel.[71] The second prong resembles the discretion of a "business judgment rule," where "courts give deference to the judgment of the board for that of the board."[72] Generally, poison pills are an effective defense strategy against a hostile takeover and their legitimacy is a settled question.[73] More importantly, poison pills fall within a broader discussion of the allocation of power between managers and shareholders.

Instead of addressing this important issue, the ongoing debate centers around whether shareholder activism sacrifices the long-term value of corporations and jeopardizes long-term performance.[74] Since the *Unocal* test imposes a rather deferential standard of review on a board's defense tactics, shareholders have no choice but to influence a board's behavior from within.[75]

This internal influence may come about through the shareholder activist using his or her partial ownership rights to influence board elections or to vote on an acquirer's offer.[76] A hostile takeover is a forceful acquisition of a target company.[77] Two methods are used by acquirers in hostile takeovers.[78] One method is a takeover through a tender offer—purchasing the target company's shares at a premium above the current market value.[79] In nearly every circumstance, the board of directors rejects the tender offer.[80] The second method communicates the tender offer directly to the shareholders, who may accept.[81] The board might accept for either the premium price or the shareholder's discontent with current management.[82]

A. Is Short-termism Threat Real?

A publicly traded company needs to have a well-balanced agenda for long-term and short-term business pressures.[83] There is no absolute optimal path of

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[71] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (1985).
[72] *Id.* at 954.
[73] Hayes, *supra* note 64.
[74] Rhee, *infra* note 123, at 496–97.
[75] Chen, *supra* note 16.
[76] *Id.*
[77] James Chen, *Hostile Takeover*, INVESTOPEDIA, https://investopedia.com/terms/h/hostiletakeover.asp (last updated Jun. 14, 2020).
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] *Id.*
[83] David A. Katz & Laura McIntosh, *The Long Term, the Short Term, and the Strategic Term*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sept. 27, 2019),

short term or long term strategies which promise a healthy business.[84] Instead, a corporation's board of directors ought to balance these perspectives in a way to maximize returns for stakeholders and long-term business health of a company.[85] Undoubtedly, "[C]orporations should not be compelled to prioritize long-term ideals any more than they should be compelled to maximize short-term profits. Business requires freedom to flourish."[86] Short-termism becomes a legitimate threat when a board of directors consistently pursues short-term returns *at the expense* of long-term interests.[87]

"Pressure toward short-termism . . . has several sources."[88] "Hedge funds and other activist investors, equity incentive compensation plans, quarterly earnings releases, and the related but separate issuance of quarterly guidance, are all important factors in promoting short-term oriented decision-making."[89] For example, some directors recognize the quarterly reporting as an inconvenience or a necessary evil.[90] The inconvenience of quarterly reporting "becomes an unnecessary distraction when there is nothing substantial to report."[91] In other words, the quarterly reporting requirement serves as a constant reminder to keep the markets informed of the corporation's well-being.[92] This becomes a problem when directors and managers seek to influence the financial statements of a corporation for a particular term to preserve the confidence of shareholders instead of adhering to a long-term agenda—an example of that would be using retained earnings to conduct large stock buybacks instead of investing in production to the point when all that is left to finance is debt.

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https://corpgov.law.harvard.edu/2019/09/27/the-long-term-the-short-term-and-the-strategic-term/.

84 *Id.*

85 *Id.*

86 *Id.*

87 *Id.*

88 *Id.*

89 *Id.*

90 Beatriz Pessoa de Araujo & Adam Robbins, *The Modern Dilemma: Balancing Short and Long Term Business Pressures*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 20, 2019), https://corpgov.law.harvard.edu/2019/06/20/the-modern-dilemma-balancing-short-and-long-term-business-pressures/.

91 *Id.*

92 *Id.*

The threat of short termism proves to be a legitimate concern when one considers the "asymmetry of legal duties" of directors and shareholders.[93] "The legal research found that in the countries surveyed, no legal duty is imposed on shareholders to protect or act in the best interests of the companies they are invested in (as, conversely, such a duty is generally imposed on the directors of those companies)."[94] Therefore, since the market is filled with investors of different breeds—hedge funds, private equity, index trackers—their return expectations and investing capabilities are not always aligned with the shareholder base.[95] For example, hedge funds may be aggressively managed or make use of derivatives—bonds, stocks, currencies—with the goal of generating high returns.[96] Although the shareholders are mindful of directors' "broader duties when making decisions regarding the management of the company's enterprise," they have no legally-recognized duty to prioritize the company's long-term value creation.[97] As a result, deviation from "director primacy" coupled with absence of a legal duty to act for the benefit of corporation by shareholders, makes the short-termism's danger dependent upon a private agenda of individual shareholders.[98]

B. *Why Should Long-Term Profit and Value Creation Be Prioritized?*

If the short-termism threat is a legitimate concern in corporate governance, it is prudent to observe why long-term profit is preferable as opposed to the short-term gains in stock price. Business strategies that are unilaterally focused on creating short-term shareholder value are increasingly under pressure.[99] Emphasizing a long-term perspective in business and strategy is more important than ever because long-term thinking in corporate governance can deliver superior and more stable financial performance than their peers.[100] Firstly, short-term thinking, for example by focusing on the share price of the company, could lead to underinvestment in research and

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[93] *Id.*
[94] *Id.*
[95] *Id.*
[96] James Chen, *What Is a Hedge* FUND, INVESTOPEDIA, https://www.investopedia.com/terms/h/hedgefund.asp (last updated June 25, 2019).
[97] Joseph L. Bower & Lynn S. Paine, *The Error at the Heart of Corporate Leadership*, HARV. BUS. REV. (May-June 2017), http://www.hbr.org/2017/05/managing-for-the-long-term.
[98] *Id.*
[99] Lars Kurznack & Raymond Timmer, *Winning Strategies for the Long Term*, KPMG GLOB. STRATEGY GRP. 1, 7 (2019), https://www.assets.kpmg/content/dam/kpmg/nl/pdf/2019/advisory/winning-strategies-for-the-long-term.pdf.
[100] *Id.*

development (R&D) and innovation.[101] Secondly, "a single focus on shareholder value creation could harm an organization's future competitiveness and resilience."[102] In the context of financial crisis, future competitiveness plays an especially important role because excessive focus on shareholder value at the expense of production and innovation reduces the company's ability unlock additional value and improve their performance. The companies that focus on a long-term value creation had proved to be more successful in a challenging economic environment.[103] For example, the long-term oriented companies had an average annual revenue growth of 6.1% as opposed to a 4.2% of their short-term oriented peers—this growth pattern remains true when only analyzing 2008 and onwards.[104]

Performance of a company *during* an economic downturn is positively correlated with its focus on the long-term profitability.[105] Randomly selected companies from the KPMG study exhibited a 16% increase in revenues in the aftermath of the financial crisis of 2008—long-term oriented companies increased their revenues by 16% during the downturn, while more short-term oriented companies showed no growth.[106] In addition, with only a 0.6% decrease in company earnings in the first year of the Global Financial Crisis, they were able to keep earnings reasonably stable, whereas short-term oriented companies suffered a 17% fall.[107] One of the key factors, which appears to account for a drastically different performance during the financial crisis of 2008, is the fact that the short-term oriented companies only respond to changing economic conditions when they are impacted—whereas the long-term oriented companies are equipped with business strategy aimed at resilience before the crisis even starts.[108]

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[101] *Id.*
[102] *Id.*
[103] *Id.*
[104] *Id.* ("One of the main objectives of this paper was to provide quantitative evidence that winning companies in the future will be those with a long-term focus in their financial, business, and operating models. For this purpose, KMPG constructed a dataset consisting of 335 listed mid- and large-cap companies from Germany (DAX + MDAX), the Netherlands (AEX), the United Kingdom (FTSE 350) and the United States (S&P 500), with a minimum reported average annual revenue greater than US$250m. Companies were selected based on random uniform selection across all sectors in the economy.")
[105] *Id.*
[106] *Id.*
[107] *Id.*
[108] *Id.*

C. *Hedge Fund Activism at the Center of Short-Termism Threat*

Hedge funds and private equity firms have generated a large amount of public debate.[109] Some argue—including hedge fund activist supporters and their academic proponents— hedge fund activism is good for shareholder value and society at large.[110] "On the other side, potential target companies, their law firms, politicians, and commentators (including academics and judges) blame it for undermining companies and long-term investment."[111] There are few reasons to suggest that hedge funds and private equity firms are primarily guided by a short-term value creation which rarely transforms into long-term business health. First, hedge fund activists have no substantial advantage in suggesting a new business or corporate governance strategy to boost production or set a new business direction.[112] Second, the way hedge funds are structured and entrusted with their clients' finances puts an enormous pressure to deliver returns in a relatively short period of time—in one or two years.[113] Since hedge funds usually require locking up clients' investment funds for a fixed period of years, clients often demand returns within a short period of time.[114] Consider this a trade-off between making the clients' investment illiquid and the clients' desire to see positive results.

The long-term is rarely the game of hedge fund activists; instead, they preach the so-called "best practices of corporate governance" in every proxy fight because it effectively mobilizes the shareholders unsatisfied with the current management.[115] In recent years, the markets saw an increase in high-profile public short-selling campaigns by activist hedge funds.[116] When short-

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[109] J.B. Heaton, *The Unfulfilled Promise of Hedge Fund Activism*, COLUM. L. SCH. BLOG ON CORPS. & CAP. MKTS. (Apr. 30, 2019), https://clsbluesky.law.columbia.edu/2019/04/30/the-unfulfilled-promise-of-hedge-fund-activism/.

[110] *Id.*

[111] *Id.*

[112] *Id.*

[113] Liekefett, *infra* note 115.

[114] James Chen, *Hedge Fund*, INVESTOPEDIA, https://www.investopedia.com/terms/h/hedgefunds.asp (last updated June 25, 2019).

[115] Kai Haakon Liekefett, *The Hypocrisy of Hedge Fund*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 4, 2018), https://corpgov.law.harvard.edu/2018/06/04/the-hypocrisy-of-hedge-fund-activists/.

[116] Ian Appel et al., *Public Short Selling by Activist Hedge* Funds, HARV. L. SCH. FORUM ON CORP. L. (Oct. 1, 2018), https://corpgov.law.harvard.edu/2018/10/01/public-short-selling-by-activist-hedge-funds/.

selling, investors open positions by borrowing shares of a stock or other asset that the investor believes will decrease in value by a set future date—the expiration date.[117] Before returning the borrowed shares, the trader is betting that the shares' price will continue declining so that they can purchase them at a lower cost.[118] The risk of loss on a short sale is theoretically unlimited since any assets' price can climb to infinity.[119]

D. Literature on the Influence of Hedge Fund Activism on Target Companies

There is literature supporting the view that hedge fund activism does not have a detrimental effect on the long-term interest of companies. Professor Lucian Bebchuk from Harvard School of Law concluded that public disclosure of activist intervention resulted in an average abnormal positive return, and after shareholder intervention, it found operation gains and no abnormal negative stock returns.[120] Professor Bebchuk's paper studied about 2,000 interventions by activist hedge funds and found no evidence that interventions—including adversarial interventions—led to long-term declines in operating performance.[121] The paper also found no evidence that the initial positive stock price spike accompanying activist interventions failed to appreciate their long-term costs, or that hedge fund activists participate in pump-and-dump patterns in which an exit of an activist is followed by abnormal, long-term negative returns.[122]

Another paper asserts that a simple application of a well-accepted asset valuation theory shows that short-termism is not per se inefficient.[123] The author further explained that "if profitable enough, a short-term strategy would be better than a long-term strategy."[124] The paper studies the circumstances surrounding a famous Delaware case, *Air Product and Chemicals, Inc. v.*

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[117] James Chen, *Short Selling*, INVESTOPEDIA, https://investopedia.com/terms/s/shortselling.asp (last updated Aug. 18, 2019).

[118] *Id.*

[119] *Id.*

[120] Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015).

[121] *Id.*

[122] *Id.*

[123] Robert J. Rhee, *Corporate Short-Termism and Intertemporal Choice,* 96 WASH. L. REV. 496 (2018).

[124] *Id.*

Airgas, Inc.—a significant hostile takeover battle.[125] Short-termism was a key fact in the court's legal analysis of the target's poison pill defense.[126] The study is based upon an intertemporal choice-model, which considers the time horizons of shareholders.[127]

Airgas, Inc. was approached with a tender offer by its competitor—Air Products & Chemicals, Inc.[128] The first all-cash offer marked at $60 per share, conditioned on the redemption of Airgas's poison pill.[129] The offer was later increased to $62 per share—Airgas's board had decidedly rejected the offer on the grounds that the price was inadequate.[130] "Undeterred, Air Products commenced a hostile takeover on February 4, 2010."[131] As the campaign progressed, the offer was upped to $63.50 on July 8, 2010, and to $65.50 per share.[132] And again, the Airgas board rejected the offers as "grossly inadequate."[133] "The takeover saga reached a fever pitch on December 9, 2010, when Air Products made its 'best and final' offer of $70 per share and set it to expire on February 15, 2011."[134] The board rejected the "best and final" offer and demanded the price of at least $78 per share.[135] After a costly and lengthy litigation battle in Delaware Chancery Court, Air Products & Chemicals, Inc. ended its bid; however, Airgas, Inc. remained highly attractive to other activists for the next several years.[136] Airgas faced another informal approach by Air Products, but this time, Airgas had to deal with an influential activist shareholder who owned a stake in Airgas.[137] Pressured by these events, Airgas sought and found a friendly offer from Air Liquide for $143 per share; acquisition closed in 2016.[138]

The study runs a counterfactual analysis of two developments—as if Airgas accepted the "best and final" offer from Air Products at $70 per share

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[125] *Id.* (citing Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48 (Del. Ch. 2011) & Airgas, Inc. v. Air Prods. & Chems., Inc., 8 A.3d 1182 (Del. 2010)).
[126] *Id.*
[127] *Id.*
[128] *Id.* at 519.
[129] Rhee, *supra* note 123.
[130] *Id.*
[131] *Id.*
[132] *Id.*
[133] *Id.*
[134] *Id.* at 521.
[135] *Id.*
[136] *Id.* at 525.
[137] *Id.*
[138] *Id.*

and the actual sale price of $143 per share.[139] Since a holding period of five years or less is defined as a short-term strategy, acceptance of a $70 per share offer would mean that the board decided to pursue short-term value.[140] In an alternative long-term strategy outcome—which actually occurred—the sale price was $143 per share with a holding period of seven to nine years.[141] Upon examination of two distinct outcomes, the paper concludes that "from a financial perspective, a tender of their shares to Air Products at $70 per share (short-term strategy), rather than to Air Liquide at $143 per share (long-term strategy), would have achieved a rate of return in the approximate range of 26%–39%, compared to long-term shareholders in the range of 18%–21%."[142] Based on these results, the paper suggests that a short-term strategy can be more desirable than long-term value creation.[143]

The reasoning in the *Airgas* paper appears to confuse two different debates which exist mutually exclusive from one another. There is no doubt that shareholder activism is capable of creating shareholder value—as shown by the *Airgas* case study.[144] However, this showing does not help in the fundamental debate—outlined in the paper's introduction section—as to whether activist short-term shareholders pressure managers to adopt strategies that increase short-term price at some cost to the firm's long-term profit.[145] Improvements of shareholder value—stock price and increase in dividends—is the feature which makes activism appealing in the first place.[146] The Airgas paper, however, does not provide any evidence that short-term strategies are compatible with long-term business health, which includes sufficient investment in research and production. Undoubtedly, the shareholder activist campaign produced additional shareholder value in the Airgas takeover battle, but the question remains open as to whether the long-term business interests have suffered. As was famously noted by Martin Lipton, a highly influential corporate lawyer, "There is no way to study the parallel universe that would exist, and the value that could be created for shareholders and other

[139] *Id.*
[140] *Id.* at 526.
[141] Rhee, *supra* note 123, at 527.
[142] *Id.* at 527.
[143] *Id.*
[144] *Id.*
[145] *Id.*
[146] Ponomareva, *supra* note 21.

constituents, if these pressures and constraints were lifted and companies and their boards and managements were free to invest for the long term."[147]

Martin Lipton, a founding partner of the law firm of Wachtel, Lipton, Rosen & Katz, voiced his disagreement with conclusion drawn in Lucian Bebchuk's paper.[148] The main grounds for criticism were methodological.[149] Mr. Lipton emphasized that the paper failed to disclose the average holding period of the activists in the study, which he states was undoubtedly less than five years.[150] Therefore, the shareholder activists could not be credited with an enhanced performance of the target companies which occurred only in the fifth year after the attack.[151] "The [Bebchuk] study sheds no light on whether the shareholders of those companies would have realized greater value from other strategic alternatives that had a longer-term investment horizon, whether those companies were pressured to sell on account of the activist attack (as other empirical work has argued), or whether shareholder gains from activism are largely driven by the cases that result in sales of control."[152] Lastly, Martin Lipton mentioned Bebchuk's concession that the analytical methodology provides no evidence of causation that activists can impair long-term value creation.[153] Since no evidence of causation was found, Mr. Lipton fairly stated that "favorable results would arise under [Bebchuk's] approach whenever managements of the target companies pursue value-enhancing strategies, even those that run counter to the activists' pressures or were being initiated even before the activist appeared."[154]

E. Success of Shareholder Activist Campaigns

The threat of short-termism is alive and well, and the success rate of activist campaigns makes it a pressing issue within the realm of corporate governance. "Some of these activists have been engaged in this type of activity for decades (e.g., Carl Icahn, Nelson Peltz)."[155] These activists were known as the "corporate raiders" because they usually sought to break up the company; they used their own funds to obtain a large portion of a target company's

[147] Martin Lipton, *The Bebchuk Syllogism*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug. 26, 2013), http://www.corpgov.law.harvard.edu/2013/08/26/the-bebchuk-syllogism/.
[148] *Id.*
[149] *Id.*
[150] *Id.*
[151] *Id.*
[152] *Id.*
[153] *Id.*
[154] *Id.*
[155] Cloyd, *supra* note 28.

shares and conduct a proxy contest for control of the board of directors.[156] "In the 1990s, new funds entered this market niche (e.g., Ralph Whitworth's Relational Investors, Robert Monks' LENS Fund, John Paulson's Paulson & Co., and Andrew Shapiro's Lawndale Capital)."[157] The founding fathers of the hedge fund activism phenomenon started raising funds from other investors and strived for minority board representation—several board seats rather than a majority—to effectuate change in corporate strategy.[158] Today, the shareholder activist arena has evolved even further, with the number of hedge funds across the globe dramatically increasing.[159] Their total assets as of 2015 exceeded $100 billion, and between 2003 and 2014, 275 new activist hedge funds were formed.[160] "Forty-one percent of today's activist hedge funds focus their efforts on North American markets,"[161] where activist hedge funds currently enjoy a success rate of about 60% in their campaigns.[162] A decline in the hedge fund activity is unlikely—even during an economic crisis.[163] There are four readily-identifiable reasons to expect an even more active shareholder involvement: (1) hedge funds and private equity funds are relatively free from the regulatory controls of the Securities Act of 1933, the Securities Exchange Act of 1934, and Investment Company Act of 1940;[164] (2) "the entrepreneurial activist is relatively undiversified and can risk a relatively large portion of its wealth on individual ventures";[165] (3) "because the underlying investors [of a hedge fund] are relatively wealthy, the activists have the financial resources to absorb large financial losses";[166] (4) most importantly, the hedge fund activist feels the momentum of support provided by the federal government in the enactment of the Sarbanes-Oxley Act and the Dodd-Frank Wall Street Reform and Consumer Protection Act.[167]

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[156] *Id.*
[157] *Id.*
[158] *Id.*
[159] *Id.*
[160] *Id.*
[161] *Id.*
[162] April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 4 (N.Y.U. Law & Econ., Research Paper No. 06–41, 2008), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=913362.
[163] *Id.*
[164] *Id.* at 5.
[165] *Id.* at 7.
[166] *Id.*
[167] Sarbanes–Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (2002).

In sum, the overall mechanism of operation suggests that hedge fund activists are well-equipped to partake in large-scale and risky campaigns.[168] Moreover, the pattern of a populist outcry against corporate America in times of financial crises has proven to favor the shareholder activist side of debate.[169] Congress enacted the Sarbanes-Oxley Act in response to several major corporate and accounting scandals, including Enron and WorldCom.[170] The Sarbanes-Oxley Act mandated CEOs lose any bonus, incentive, or equity-based compensation if their corporation restated financial statements due to "misconduct."[171] Whereas, the Dodd-Frank Act—enacted in the aftermath of the 2008 financial crisis—introduced the "say-on-pay" principle, which mandates the practice of granting shareholders the right to vote on a company's executive compensation program.[172] As stated above, the aforementioned legislations symbolize departure from the principle of "director primacy," thereby setting an alarming precedent where the leadership of corporate America gets penalized and regulated for behavior that was encouraged by influential policy entrepreneurs supporting those legislative acts.[173]

It is much more attractive for a presidential candidate or politician to assume the image of the people's champion, not the fighter for the interests of "fat corporate cats."[174] For example, "During the 2008 Presidential campaign, . . . Senator John McCain 'blasted what he called the "outrageous" and "unconscionable" rewards received by leaders of Bear Stearns Cos. and Countrywide Financial Corp. despite the credit crisis.'"[175] Similarly, a political ad by then-Senator Barack Obama attacked "chief executives 'who [were] making more in 10 minutes than ordinary workers [were] making in a year.'"[176] After the financial crisis strikes—be it a recession or major corporate scandal—the coinciding interests of politicians up for election and the shareholder activists striving for more power in a boardroom have a perfect moment to mobilize their efforts and condone the risk takers who drove the economy into a ditch.[177] Little does the ordinary public know that the ever-

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[168] Klein, *supra* note 162, at 189.

[169] BAINBRIDGE, *supra* note 7.

[170] Sarbanes-Oxley Act, *supra* note 167.

[171] BAINBRIDGE, *supra* note 7, at 129.

[172] Joseph E. Bachelder III, *Say-on-Pay Under Dodd-Frank*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sept. 17, 2011), https://corpgov.law.harvard.edu/2011/09/17/say-on-pay-under-dodd-frank/.

[173] Sarbanes-Oxley Act, *supra* note 167.

[174] *See* Bainbridge, *supra* note 7.

[175] *Id.* at 109.

[176] *Id.*

[177] *Id.*

increasing risks taken by corporate directors are indirectly dictated by the laws which give shareholders more say in the boardroom.[178] Based on the experiences with the Sarbanes-Oxley Act and the Dodd-Frank Act, the two-decade trend suggests further legislative action moving closer towards "shareholder primacy" as a response to the next financial crisis.[179]

F. *Why Is Planning Against Shareholder Activism More Crucial than Ever?*

Shareholder Activism by institutional investors undoubtedly serves as an indicator that the current corporate governance system has flaws.[180] "Looking at antecedents of shareholder activism, there are four areas within a firm in which researchers have found antecedents of shareholder activism: the firm, the CEO, the board of directors and ownership."[181] In other words, "the 'demand' and 'supply' factors . . . shape the market for corporate influence and in so doing outline[] the variables likely to determine levels of offensive shareholder activism over time."[182]

It is prudent to emphasize that shareholder activist campaigns will continue being utilized as a weapon to acquire seats on corporate boards so long as defensive mechanisms installed by legal counsel can be compromised. "Essentially, the opportunities for the profitable exercise of influence determine the 'supply side' of this market while the willingness of investors to pursue such opportunities defines the 'demand side.'"[183] To observe the supply and demand for the shareholder activist campaigns, it is prudent to give

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[178] *Id.* at 136.

[179] Sarbanes-Oxley Act, *supra* note 167.

[180] Maureen I. Muller-Kahle, *What Is Influencing Financially-Driven Shareholder Activism in the US and UK—Principal-Agent or Principal-Principal Problems?*, (2010) (Ph.D. dissertation, Old Dominion University) (on file with the ODU Digital Commons).

[181] *Id.*

[182] Brian R. Cheffins & John Armour, *The Past, Present and Future of Shareholder Activism by Hedge Funds*, 38 U. CAMBRIDGE LEGAL STUD. RES. PAPER SERIES 1, 6 (2011) (explaining that the rise of hedge funds as practitioners of offensive shareholder activism is traced by reference to the supply and demand sides of the corporate governance market).

[183] *Id.* at 28.

a thorough historical background of how shareholder activism came to existence and the tremendous momentum it gained for the past decades.

IV. HISTORICAL BACKGROUND

"[O]ffensive shareholder activism occurred at various junctures during the first half of the 20th century."[184] In the 1950s, the hedge fund activity within the activist realm was not on a horizon, however, the so-called "proxyteers"[185] were able to make a name for themselves as corporate insurgents after launching proxy battles contesting board control in major U.S. public companies.[186] Hedge-fund activism as corporate America knows it today began its journey in 1980s.[187] That decade became known as "the Deal Decade," which symbolized "aggressive, innovative financial techniques to engineer daring takeover bids."[188] The raiders, who strived for corporate control, "bought and held . . . stakes in companies in the manner associated with offensive shareholder activism."[189] In the 1980s, investors like Charles Bludhorn and Irwin Jacobs used mutual funds to carry out their hostile transactions.[190] The safe harbor of the Investment Company Act of 1940 likely influenced the raiders' decision to operate through a dimension of private

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[184] *Id.* at 42.

[185] Jeff Gramm, *The Activist Playbook Is Nearly 90 Years Old — and the First Chapter Was Written by Warren Buffet's Mentor,* BUS. INSIDER (June 16, 2016), https://www.businessinsider.com/benjamin-graham-was-the-first-shareholder-activist-2016-6 ("When the US economy began to expand after the end of World War II, a group of aggressive young men, dubbed the Proxyteers, targeted underperforming companies, including household names like Montgomery Ward and Twentieth-Century Fox.").

[186] *Id.*

[187] Cheffins & Armour, *supra* note 182.

[188] *Id.*

[189] *Id.* at 43. Charles Bludhorn—chairman of the conglomerate Gulf & Western and ranked 61st in the Fortune 500 by 1981—"hunted for undervalued companies." *Id.* "As of 1981, Gulf & Western owned minority holdings of 20% or more in five companies and at least 5% in nearly a dozen more." *Id.*

[190] *Id. "*Irwin Jacobs, who during the 1980s bought up sizeable stakes in numerous public companies but only rarely followed through on promises to bid for full control, started out doing deals personally or with a small group of private investors but then used Minstar, a public company in which he held a 37% stake, as the vehicle for his transactions. Similarly, T. Boone Pickens, who orchestrated the acquisition of sizeable stakes in numerous companies but rarely achieved his declared objective of obtaining full voting control, used Mesa Petroleum Co., a public company he founded in the 1960s, to carry out his best-known forays." *Id.* at 43–44.

investment funds instead of publicly traded companies.[191] "While during the 1980s offensive shareholder activism was typically carried out through the medium of a publicly traded company, during this decade a tiny handful of activists began operating through the medium of private investment funds."[192] These pioneers served as the "antecedents to activist hedge funds," and at least two large-scale "activists of the [early] 2000s can be traced back to the end of the Deal Decade."[193]

> Edward Lampert's ESL Investments, which generated headlines in the 2000s with investments in retailers Kmart and Sears, is another high-profile activist hedge fund with a history extending back to the end of the Deal Decade. In 1998 Lampert, then aged [twenty-six], launched ESL as a private partnership and quickly parlayed a reputation for identifying undervalued stocks into financial backing from various wealthy investors. ESL suffered heavy losses in a 'bear' stock market in 1990 and 1991 and Lambert [sic], eager to ride out future market fluctuations undisrupted, asked his investors to lock their money into the partnership for five years and agreed in return not to take in any new partners until 1998. Such restraint likely accounts for the fact that Lampert was, according to the *Wall Street Journal*, a 'lesser-known' activist in 2001 despite delivering returns averaging 29% annually between 1988 and 2004.[194]

In the 1990s, a transitional period for hedge fund activism, hedge funds became a prominent investment option, but hedge fund managers were slow to embrace the activist reputation.[195] "Headlines from the New York Times reflect these trends, proclaiming in 1995 'Hedge

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[191] *Id.* at 44. "The Act restricts in various ways the ability of firms falling within its purview (e.g. mutual funds) to carry out the sort of offensive activism engaged in during the Deal Decade. However, publicly traded companies having a business of their own and having no more than 40% of total assets invested in stocks of other companies operate free form the Act's strictures." *Id.*

[192] *Id.*

[193] *Id.* at 44–45.

[194] *Id.* at 45–46. Just as in a traditional hedge fund—where investors make their money illiquid for duration of lock-up period—Edward Lampert required his investors to commit to a five-year lock-up period, thereby echoing a hedge fund technicality. *Id.*

[195] *Id.* at 48–49.

Funds Still Steaming Ahead' and asking in 1996 'Where, Oh Where, Have All the Corporate Raiders Gone?'"[196] Indeed, at least 1,949 financial entities were designed to "hedge"[197] risks that were not within the reach of the Investment Company Act of 1940.[198] However, there were approximately only 300 hedge funds in America with roughly $40 billion at their disposal compared to mutual fund portfolios, which accounted for $1.6 trillion.[199] Arguably, the banking industry was an exception.[200]

> In 1996, *U.S. Banker* ran a cover story entitled 'Banking's TOUGHEST Owners' that opened with a description of Stephen Gordon, the then 33-year-old former investment banker running Genesis Financial Partners, who 'loves to take big positions in community-based financial institutions with lackluster performance records. Then he starts throwing his weight around.'[201]

Therefore, although hedge funds became more noticeable on the market, they did not achieve notoriety within the realm of shareholder activism.[202]

However, the 2000s market brought a striking contrast, where new investment approaches were in the spotlight.[203] Articles from reputable publications on financial affairs described a surge in shareholder activism as a novice and developing phenomenon.[204]

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[196] *Id.* at 49. *See also* Laurence Zuckerman, *Hedge Funds Still 'Steaming Ahead'*, N.Y. TIMES (Jan. 25, 1995), https://nytimes.com/1995/01/25/business/hedge-funds-still-steaming-ahead.html; Margaret Isa, *Where, Oh Where, Have All the Corporate Raiders Gone?*, N.Y. TIMES (June 30, 1996), https://nytimes.com/1996/06/30/business/where-oh-where-have-all-the-corporate-raiders-gone.html.

[197] Nathan Reiff, *Hedge*, INVESTOPEDIA, https://www.investopedia.com/terms/h/hedge.asp (last updated Feb. 1, 2020) (explaining that hedge is an investment made to reduce "the risk of adverse price movements in an asset"—usually "taking an offsetting position in a related security").

[198] Cheffins & Armour, *supra* note 182, at 49.

[199] *Id.*

[200] *Id.* at 51.

[201] *Id.*

[202] *Id.*

[203] *Id.* at 52.

[204] *Id.* at 52–53. "In 2001, the *Wall Street Journal* drew attention to the fact 'dissatisfied shareholders are aggressively pushing companies to find new ways to unlock shareholder value' and said that 'among the growing ranks of activists are . . . even hedge-fund managers, who historically have been relatively passive.'

> That is the word from well-known Martin Lipton, who advises corporate executives and boards, entrenched and otherwise. Mr. Lipton sent his clients a memo . . . that warned against overreacting to Sarbanes-Oxley [Act], and instead listed the No. 1 issue for directors as 'anticipating attacks by activist hedge funds seeking strategy changes by the company to boost the price of the stock.'[205]

Mr. Lipton—one of the main advocates against shareholder activism—emphasized, as this comment noted above, that Sarbanes-Oxley Act should not be feared too much.[206] More specifically, a prominent lawyer consulting boards and executives on compliance with corporate governance laws explicitly state, the narrowly tailored clawback provision of Sarbanes-Oxley is an ineffective piece of legislation. What has, and continues, to be dangerous for the boards are the attacks by activists whose main instinct is to drive the stock price up. Once the activists have taken a corporation over, the "say on pay" and other provisions of Dodd-Frank will equip them with tools to have directors run after quarterly statements to remain on a board.

At some point in 2006, the founder of Chapman Capital LLC—private investment firm that provides services to corporate and institutional clients—complained that "what had been a niche area had become a crowded field with

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Business Week featured hedge funds Highfields Capital Management and Chapman Capital LLC in a 2002 article on 'value investors' minded to challenge existing management for the sake of value creation, saying 'Their style of investing is taking off like a Fourth of July bottle rocket.' *Institutional Investor* observed similarly in 2003 'No-nonsense, seize-the-board, put-the-company-in-play, do-whatever-it-takes-to-increase-the-stock-price corporate activism is coming back into style—and hedge funds are at the cutting-and-slashing edge.'" *Id.*

[205] Alan Murray, *Hedge Funds are New Sheriffs of Boardroom*, THE WALL ST. J. (Dec. 14, 2005), https://www.wsj.com/articles/SB113451884230621753; *see* Deedee Myers & DDJ Myers, *The Value, or Cost, of an Entrenched Board*, CUINSIGHT (Oct. 3, 2016), https://www.cuinsight.com/value-cost-entrenched-board.html. An entrenched board of directors is when the directors have a firm grip on the board and have very little accountability to the shareholders. *Id.* For example, a strategy used by the directors which tends to make it entrenched is the so-called staggering of the board—"a board that is made up of different classes of directors with different service terms." *What Is a Staggered Board?*, INVESTOPEDIA, https://www.investopedia.com/ask/answers/05/staggeredboard.asp (last updated Jan. 31, 2020).

[206] Murray, *supra* note 205.

numerous hedge funds competing for activist opportunities using similar strategies."[207]

Today, as we turn back to the early 2000s and observe an undisturbed and swift evolution of hedge fund activism, there is no choice but to acknowledge that shareholder activism is well and on the rise.[208] "A year-by-year breakdown of Robin Greenwood and Michael Schor's dataset of 784 hedge fund activism campaign launched between 1994 and 2006 reveals similarly that activism events became progressively more common throughout this period."[209] According to Greenwood and Schor, the transition from 2004 to 2005 has seen an increase in the amount of hedge fund activist campaigns by 100%—from 70 campaigns in 2004 to 140 campaigns in 2005.[210] Also, Lazard's Annual Review of Shareholder Activism for 2018 displays numbers that should be welcomed by activists and feared by the boards of directors.[211] More importantly—since this comment is concerned with hedge fund activism in the U.S.— it is prudent to note that "[a]ctivists launched 205 new campaigns through the end of August and won 76 board seats, as compared to 203 new campaigns and 113 board seats through the end of August last year."[212]

A. Shareholder Activism for the Past Decade

Although the numbers reflecting total campaigns are substantial, is there a sufficient rate of success to warrant precautionary measures of American corporate boards? Activists continued their endeavors in 2019, consistent with prior years.[213] "Activists launched 205 new campaigns through

[207] Cheffins & Armour, *supra* note 182 at 53.

[208] *The Evolution of Shareholder Activism*, BLOOMBERG PROF. SERV. (Feb. 20, 2015), https://www.bloomberg.com/professional/blog/shareholder-activism/.

[209] Cheffins & Armour, *supra* note 182, at 53–54. *See* Robin Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON. 362, 365 (2009).

[210] Cheffins & Armour, *supra* note 182, at 54.

[211] Lazards's Shareholder Advisory Group, *2018 Review of Shareholder Activism*, LAZARD (Jan. 9, 2019), https://www.lazard.com/media/450805/lazards-2018-review-of-shareholder-activism.pdf (showing that the average amount of activist campaigns from 2013-2018 was 171—with 139 campaigns in 2013; 172 campaigns in 2014; 188 campaigns in 2015; 168 campaigns in 2016; 188 campaigns in 2017; and 226 campaigns in 2018).

[212] Melissa Sawyer, *Annual Review and Analysis of 2019 U.S. Shareholder Activism*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 20, 2019), http://corpgov.law.harvard.edu/2019/11/20/annual-review-and-analysis-of-2019-u-s-shareholder-activism/.

[213] *Id.* "The total number of campaigns has been remarkably consistent over the past five years with an average of approximately 272 campaigns announced per year." *Id*.

the end of August and won 76 board seats, as compared to 203 new campaigns and 113 board seats through the end of August last year."[214] For instance, the most prominent activists—Starboard, Icahn, Ancora, and Elliott—initiated new campaigns with more than substantial amounts of cash.[215] Although there is plenty of data regarding the public campaigns announced by activists, one should bear in mind that these numbers do not provide a complete coverage of that activity—"a significant number of activist situations also are being resolved without publicity."[216] Publicity is often times avoided altogether, when the target company and activists execute a settlement agreement[217] before publicly announcing a campaign or initiating a full-scale proxy contest.[218]

"Board seats obtained per announced campaign remain at elevated levels, as activists on average obtained 0.7 board seats per 2019 [completed] campaign (a 35% increase from 2017)."[219] Once the settlement agreement is reached, what are the ultimate benefits for a shareholder activist as a reward following costly and timely campaign?

Settlement agreements can include: (1) nomination provisions and minimum shareholding provisions, (2) committee membership arrangements, (3) information sharing arrangements, (4) standstill provisions, (5) voting agreements, and (6) appointment of fund-insiders by select activists.[220]

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[214] *Id.*

[215] *Id.* "Elliott, Icahn and Third Point led all funds with $3.4 billion, $2.8 billion and $1.5 billion in capital deployed in activist campaigns in the first half of 2019, respectively." *Id.*

[216] *Id.*

[217] Kai Haakon E. Liekefett & Leonard Wood, *Help! I Settled With an Activist!*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 11, 2019), https://corpgov.law.harvard.edu/2019/06/11/help-i-settled-with-an-activist/. A well-crafted settlement agreement usually buys peace for some time and prevents future campaigns in the foreseeable future. However, after executing a settlement agreement, the activists tend to have one or more activist designees join the board. *Id*.

[218] James Chen, *Proxy Fight*, INVESTOPEDIA (July 9, 2020), https://www.investopedia.com/terms/p/proxyfight.asp ("Sometimes referred to as a 'proxy battle,' this action is mainly used in corporate takeovers. . . . [where] outside acquirers may attempt to convince existing shareholders to vote out some (or all) of a company's senior management to make it easier to seize control over the organization.").

[219] Sawyer, *supra* note 212.

[220] *Id.* at 24–35.

A majority of settlement agreements contain the appointment of a director to the board—sometimes the agreements provide "for mere nomination of a director candidate or some other arrangement."[221] In 2019, Sullivan & Cromwell LLP observed that 73% of settlement agreements contained a provision prescribing committee membership for the activist-backed director—those committees were "Strategic Alternatives Committee," "Financial Operating Committee," "Risk & Compliance Committee," and "CEO Search Committee."[222] Clearly, appointments to such committees give activist-backed directors additional say in future business affairs of a target company.[223] However, the target company generally makes sure to include the so-called standstill provision, "which prohibits activists from engaging in certain activities within a prescribed period of time."[224] The standstill provision can further establish a requirement that the activists cast their votes in a certain way during the standstill period.[225]

Given the success rate of activist campaigns and their ability to win seats within a board, corporate attorneys and experts in the field do not expect a decline in future takeover attempts.[226] Also, in the first quarter of 2019, activist hedge funds experienced positive net asset flows—which suggest that activists continue to pool more resources for fierce attacks in the future.[227]

V. ACCOUNTING STUDY OF PRE- AND POST-TAKEOVER PERFORMANCE IN TARGET COMPANIES

It is prudent to note that there is not much literature on target companies' performance before and after an activist attack.[228] Nor does it seem possible to conduct a study which would measure the target company's performance with or without an activist intervention.[229] As Martin Lipton stated, "There is no way to study the parallel universe that would exist, and the value that could be created for shareholders and other constituents, if these

[221] Sawyer, *supra* note 212, at 26.
[222] *Id.* at 27.
[223] *Id.*
[224] *Id.* at 28.
[225] *Id.* at 31. Eighty-seven percent of settlement agreements in 2019 contained a voting agreement provision. *Id.*
[226] *Id.* at 14.
[227] *Id.* at 17.
[228] Möhlmann, *supra* note 59, at 8.
[229] Lipton, *supra* note 147.

pressures and constraints were lifted and companies and their boards and managements were free to invest for the long term."[230]

A paper by B.W.A. Möhlmann is one of the few efforts to study the pre- and post-takeover performance of target companies.[231] The ultimate conclusion of Möhlmann's paper is that there is "significant evidence that shareholder value for acquiring companies is destroyed by pursuing a hostile takeover."[232] Shareholder activists, on the other hand, strongly support the so-called the "disciplining theory", which suggests that an everlasting possibility of a hostile takeover keeps the board of directors constantly accountable to shareholders' interests.[233] As Möhlmann anticipated, "[I]t is concluded that there is no convincing support for the disciplining theory suggesting pre-takeover underperformance of hostile targets. In addition, the implicitly assumed outperformance of hostile acquirers in the pre-takeover stage has

[230] *Id.*

[231] Möhlmann, *supra* note 59, at 8 ("To the knowledge of author, there has not been performed a similar study that researches to what extent hostile takeovers have proven to create value for acquiring shareholders of US Companies."). *Contra* Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1155 (2015) ("Going forward, policymakers and institutional investors should not accept the validity of the frequent assertions that activist interventions are costly to firms and their shareholders in the long term. Both public officials and investors should reject any use of such claims as a basis for limiting the powers, rights, and involvement of shareholders."). *But see* Martin Lipton, *The Bebchuk Syllogism*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Aug. 26, 2013), http://www.corpgov.law.harvard.edu/2013/08/26/the-bebchuk-syllogism/ (criticizing Lucian Bebchuk's study of shareholder activism based upon Tobin Q indicators, because companies that forego profitable investment opportunities—including as a result of pressure from activists to return capital to investors or defer investments in Research & Development and Capital Expenditure—can actually have higher Q rations while reducing shareholder value that would have been generated by those investments.).

[232] *Id.* at 70.

[233] *Id.* at 31. ("In active markets for corporate control, takeovers are, according to the disciplining hypothesis, effective tools to discipline management. The disciplining theory, also called the inefficient management hypothesis, is based on the notion that target companies are managed at suboptimal levels. While all firms can theoretically be improved by better management, Agrawal and Jaffe (2003) argued that the potential for improvement is clearly greater in firms that are managed poorly. As a consequence, firms with greater unexploited opportunities are recognised [sic] as natural candidates for (hostile) takeovers by Brealy and Myers (1991) and Schwert (2000).").

found significant support."[234] In other words, Möhlmann found no evidence that the companies subject to shareholder activist campaigns have poor pre-takeover returns.[235] The study analyzed data between hostile and non-hostile takeovers compared to their relevant benchmark companies that have not been subjected to takeovers.[236] The two-paired samples are hostile and friendly takeovers.[237]

A. *Pre-takeover Performance*

To evaluate the pre-takeover performance of a hostile acquirer and a target company, abnormal profit indictor was analyzed.[238] Generally, the hostile targets exhibited positive abnormal returns in the pre-takeover period.[239] "Comparing the . . . [abnormal profit] of hostile and friendly *acquirers*, the results show that friendly acquirers significantly *outperform* hostile acquirers [for the duration of 2 years before the takeover], as well as in the three-year average."[240]

An identical analysis was conducted for the pre-takeover abnormal *stock returns*[241]—defined as the buy-and-hold abnormal returns (BHAR), and calculated as the change in stock price and includes dividends.[242] "For hostile

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[234] *Id.* at 70.

[235] *Id.* at 70.

[236] James Chen, *Benchmark*, INVESTOPEDIA, https://www.investopedia.com/terms/b/benchmark.asp (last updated June 16, 2019). "A benchmark is a standard against which the performance of a security, mutual fund or investment manager can be measured. Generally, broad market and market-segment stock and bond indexes are used for this purpose." *Id.*

[237] *Id.* at 54.

[238] Alan Deardoff, *Excess Profit Definition*, DEARDOFF'S GLOSSARY OF INT'L ECON., http://www-personal.umich.edu/~alandear/glossary/e.html#ExcessProfit. Excess profit (aka abnormal profit) is "profit of a firm over and above what provides its owners with a normal (market equilibrium) return to capital." *Id.*

[239] *Id.* at 55.

[240] *Id.* "The median abnormal returns are reported for each (fiscal) year -3, -2 and -1, for the change in abnormal return from year -2 to year -1 and from year -3 to year -1, and ultimately for the average abnormal returns of the *three pre-takeover years*." *Id.*

[241] *Stock Market Returns*, ECON. WATCH (Nov. 23, 2010), https://www.economywatch.com/stock-markets-in-world/returns.html. "Stock Market Returns are the returns that the investors generate out of the stock market. This return could be in the form of profit through trading or in the form of dividends given by the company to its shareholders from time-to-time." *Id.*

[242] *Id.* at 57. "The BHAR of the sample is calculated relative to a non-merging benchmark [company] that is matched in size, industry and market-to-book ratio." *Id.*

takeovers, target performance exceeds acquirer performance [3 years before the takeover, especially in the second year], but is reversed [1 year before the takeover]," which suggests that activists who preach more dividends and disbursement of shareholder value, in fact, tend to issue fewer dividends two or three years prior to a takeover.[243]

B. *Post-takeover Performance*

Supporters of shareholder activism and hostile takeovers argue that takeovers lead to an overall creation of wealth.[244] But Möhlmann's study went further and analyzed "[the] extent [to which] value is created for acquiring shareholders."[245] Similarly to pre-takeover performance analysis, the paper analyzed the *post-takeover* abnormal profit returns of acquirers, which in theory is supposed to improve from years -1, -2, or -3 if activists' intervention creates long-term value.[246]

C. *Möhlmann's Conclusion and Verdict*

Contrary to activists' expectations, "[The Study] shows consistent and significant *underperformance* of hostile acquirers compared to their benchmark companies."[247] More specifically, the study showed "consistent and significant underperformance of hostile acquirers compared to their

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See Will Kenton, *Book-To-Market-Ratio Definition*, INVESTOPEDIA, https://www.investopedia.com/terms/b/booktomarketratio.asp (last updated July 1, 2019). "The book-to-market ratio is used to find a company's value by comparing its book value to its market value. A company's book value is calculated by looking at the company's historical cost, or accounting value. A firm's market value is determined by its share price in the stock market and the number of shares it has outstanding, which is its market capitalization." *Id.*

[243] *Id.* at 59.

[244] *Id.*

[245] *Id.* at 60.

[246] *Id.* "The abnormal returns are aggregated, with relative asset size used as weights, to be able to compare pre-takeover returns to post-takeover returns." *Id. See* James Chen, *Cumulative Return Definition*, INVESTOPEDIA, https://www.investopedia.com/terms/c/cumulativereturn.asp (last updated Mar. 28, 2019) (explaining that the a cumulative return on an investment is the aggregate amount that the investment has gained or lost over time, independent of the period of time involved—presented as a percentage, the cumulative return is the raw mathematical return of the following calculation: (current price of security) - (original price of security) = x; x/original price of security).

[247] *Id.*

benchmark in terms of profit returns — -2.9% one year after a takeover; -3.0% two years after the takeover; -4.1% three years after the takeover."[248] By contrast, importantly, the friendly takeovers—implemented without an adversarial campaign or tender offer—exhibited "consistent and significant" *positive* returns in post-takeover years (e.g., 1, 2, 3).[249]

The stock returns of the post-takeover hostile acquirers also exhibited results that ran contrary to activists' praises—negative, although largely *insignificant* results.[250]

VI. THE VICIOUS CYCLE EXPLAINED

As discussed above, shareholder activists—composed mostly of institutional investors—successfully conducted hostile takeover campaigns for the past couple of decades, as well as achieved significant victories in the legislative arena.[251] This paper has explained particular legislative efforts that occurred in the aftermath of the financial crisis, which granted the shareholders theoretically nonbinding, but highly effective "say on pay" under the Dodd-Frank Act.[252] Also, the legislative efforts backed by institutional investors and trade associations exhibited provisions that turned out to be overinclusive and virtually impossible to enforce, the clawback provision of the Sarbanes-Oxley Act.[253] But, more importantly, regardless of whether the provision vested shareholders with more power in the realm of corporate governance, or simply created a vacuum regulation, any legislative victory by activists was preceded by massive populist hysteria, for example the financial crisis of 2008 or the Enron accounting scandal in Dodd-Frank and Sarbanes-Oxley, respectively.[254] The populist outcry against corporate executives as

[248] *Id.*

[249] *Id.* As per Panel C, "[B]oth hostile as friendly acquirers perform *significantly* worse than the combined pre-takeover firm (-2.7% and -0.5% respectively). This is remarkable as one would expect hostile acquirers to be more profitable compared to their benchmarks. This entails that, relative to the benchmarks, there is no improvement in performance. In other words, results show that hostile takeovers do not add value in terms of profit for acquiring shareholders." *Id.*

[250] *Id.* at 62. In Möhlmann's paper, the researcher designated significant levels of 1%, 5%, and 10%—marked by asterisks in tables as (***)(**)(*), respectively. Therefore, "significant results" within current discussion are the ones that reach either 1%, 5%, or 10% mark. *Id.* at 54.

[251] *See* discussion *supra* Section III.

[252] *Id.*

[253] *Id.*

[254] *Id.*

well as the struggle of the "little guy" with powerful corporate America seems to be everlasting throughout our Republic's history.

When the Sarbanes-Oxley Act was passed, it contained the aforementioned clawback provision, which was dismissed as insignificant by one of the foremost lawyers, consulting with boards across the country—Martin Lipton of Wachtell, Lipton, Rosen & Katz.[255] But, under the drum of righteous battle against the corporate chiefs, Sarbanes-Oxley placed some limitations on executive pay and mandated the aforementioned clawback provision.[256] Such legislation, along with Dodd-Frank, provides the activists with a clearer path to follow for acquiring new boards and effectuating new changes.[257] For instance, after the passage of the "say on pay" provision, the activist investors know that upon mobilization of sufficient shares—aside from an opportunity to vote the directors out at the next annual election—they have additional leverage when issuing the advisory opinion on executive compensation.[258]

The newly available tools and leverage—created, at least in part, due to a populist sentiment against corporations—reinforces the economic feasibility of activist campaigns as an investment endeavor. This comment has thoroughly studied the historical evolution of the corporate raiders, as well as the realm of hedge fund activism for the past decade.[259] For example, in 2019, activists launched 205 new campaigns and won 76 board seats, as compared to 203 campaigns and 113 seats through the end of August of 2018—showing a steady increase in the campaign amount, as well as consistent demand in activist services.[260]

After considering the legislative victories and newly created leverage tools, it is prudent to note that the newly acquired corporations will tend to exhibit decisions that differ from that of a previous management. The new corporate strategy—now controlled by institutional investors who completed the takeover—dictates constant improvement of the stock price, which is also known as "race after numbers."[261] In the worst-case scenario, if the stock price

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[255] *See* discussion *supra* Section V.
[256] *See* discussion *supra* Section III.
[257] *See* discussion *supra* Section II.
[258] *See* discussion *supra* Section III.
[259] *See* discussion *supra* Section V.
[260] *See* discussion *supra* Section V.A.
[261] BAINBRIDGE, *supra* note 7, at 119.

did not "make the number," the executive compensation might face catastrophic consequences through "say on pay" advisory opinion.[262]

The accounting analysis in this paper supports the proposition that hostile takeovers tend to destroy shareholder value in the long term—shows consistent and significant underperformance of hostile acquirers compared to their benchmark companies as pertaining to profit returns and stock returns.[263] A vivid example is the hostile takeover of the international pharmaceutical company, Allergan. [264]

When one combines the "race after numbers" behavior, which usually comes at the expense of investment in research and technology, and pro-activist legislation, such as say on pay—serving as a vivid reminder for directors to be responsive to the numbers race—we continue the cyclical movement toward another financial crisis.[265] The movement will continue until the Congress—filled with "warriors for the ordinary folk"—will side with activists an make another step away from the board centrism.

VII. CONCLUSION

Although there is a very limited amount of literature regarding the influence of hedge fund activism on the corporation's long-term value creation, the data available suggests that hostile acquirers do consistently worse than the benchmark companies in the long run. This paper analyzed the historical development of the shareholder activism phenomenon and showed that the hostile takeover is likely to continue increasing in numbers and success rate. The legislative responses—enacted in response to financial downturns—require thorough attention on behalf of the gatekeepers who work to protect the boards from takeovers. Those gatekeepers are attorneys who provide a corporation with meaningful defense mechanisms against hostile takeovers. This paper calls for increased awareness because the federal government—whose intervention is always reactive and not pro-active—tends to be seduced by the desire to continue a fight against corporate "fat cats." As in example of Sarbanes-Oxley and Dodd-Frank Acts, it is evident that the trade associations—CII etc.—backed by hedge funds and institutional investors

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262 *Id.*

263 *See* discussion *supra* Section VI.

264 Bower & Paine, *supra* note 97 ("Once Allergan's management shifted its focus from sustaining long-term growth to getting the company's stock price to $180 a share—the target at which institutional investors were willing to hold their shares—its priorities changed accordingly. *Research was cut, investments were eliminated, and employees were dismissed*.").

265 See *supra* text accompanying note 8.

tend to join the virtuous bandwagon for the sake of their personal financial gain. Since we are to expect further departure from the centrism of the board, wise defense planning—be it poison pills, shareholder rights plan, or golden parachutes—is the best hope to contain the activist momentum that continues to ruin long-term health being of American corporations.