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Hedge Funds in Corporate Governance and Corporate Control

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Hedge Funds in Corporate Governance and Corporate Control

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Abstract

Hedge funds have become critical players in both corporate governance and corporate control. In this article, we document and examine the nature of hedge fund activism, how and why it differs from activism by traditional institutional investors, and its implications for corporate governance and regulatory reform. We argue that hedge fund activism differs from activism by traditional institutions in several ways: it is directed at significant changes in individual companies (rather than small, systemic changes), it entails higher costs, and it is strategic and ex ante (rather than intermittent and ex post). The reasons for these differences may lie in the incentive structures of hedge fund managers as well as in the fact that traditional institutions face regulatory barriers, political constraints, or conflicts of interest that make activism less profitable than it is for hedge funds. But the differences may also be due to the fact that traditional institutions pursue a diversification strategy that is difficult to combine with strategic activism.

Although hedge funds hold great promise as active shareholders, their intense involvement in corporate governance and control also potentially raises two kinds of problems: The interests of hedge funds sometimes diverge from those of their fellow shareholders; and the intensity of hedge fund activism imposes substantial stress that the regulatory system may not be able to withstand. The resulting problems, however, are relatively isolated and narrow, do not broadly undermine the value of hedge fund activism as a whole, and do not warrant major additional regulatory interventions.

The sharpest accusation leveled against activist funds is that activism is designed to achieve a short-term payoff at the expense of long-term profitability. Although we consider this a potentially serious problem that arguably pervades hedge fund activism, we conclude that a sufficient case for *legal* intervention has not been made. This conclusion results from the uncertainties about whether short-termism is in fact a real problem and how much hedge fund activism is driven by excessive short-termism. But, most importantly, it stems from our view that market forces and adaptive devices taken by companies individually are better designed than regulation to deal with the potential negative effects of hedge fund short-termism while preserving the positive effects of hedge-fund activism.

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Introduction

Hedge funds[1] have become critical players in both corporate governance and corporate control. Over the last few months, hedge funds have pressured McDonalds to spin-off major assets in an IPO;[2] asked Time-Warner to change its business strategy;[3] threatened or commenced proxy contests over H.J. Heinz,[4] Massey Energy,[5] KT&G,[6] infoUSA,[7] Sitel,[8] and GenCorp;[9] made a bid to acquire Houston Exploration;[10] pushed for a merger between Euronext and Deutsche Boerse;[11] pushed for changes in management and strategy at Nabi Biopharmaceuticals;[12] opposed acquisitions by Novartis of the remaining 58% stake in Chiron,[13] by Sears Holdings of the 46% minority interest in Sears Canada,[14] by Micron of Lexar Media,[15] and by a group of private equity firms of VNU;[16]

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[1] For purposes of this article, hedge funds are funds exempt from regulation under the Investment Company Act that invest primarily in publicly traded securities or financial derivatives. See www.hedgefund.com/abouthfs/what/what.htm (defining hedge funds in a similar way).

[2] Big Shareholder of McDonald's Urges Asset IPO, Wall St. J., Nov. 9, 2005, at A6; Hedge-Fund Man at McDonalds's, Wall St. J., Sept. 28, 2005, at C1 (noting pressure by Pershing Square, a hedge fund, in McDonald's Corp., to sell company-owned restaurants).

[3] Andrew Ross Sorkin & Richard Siklos, Icahn Tries to Form a Team to Take On Time Warner, NYT, Aug. 10, 2005, printout; Julia Angwin, Icahn Issues Time Warner Challenge – Financier Confirms Alliance With Other Investors to Seek Changes at Media Company, Wall St. J., Aug. 16, 2005, at A3.

[4] Janey Adamy & David Reilley, Heinz Says Investor's Company Plans to Nominate 5 Directors, Wall St. J., Mar. 4, 2006, at B2.

[5] AP Wire, Investment Company Wants Representation on Massey's Board, Mar. 17, 2006

[6] Seon-Jin Cha, Icahn Group Demands access to KT&G Books, Wall St. J., Mar. 15, 2006 at C4; Laura Santini, Icahn Group Lands KT&G Board Seat, Wall St. J., mar. 17, 2006 at C4..

[7] InfoUSA tells shareholders to ignore hedge fund, Reuters, May 4, 2006.

[8] JANA Partners LLC Announces SITEL Board Nominees and Intention to Replace Additional Board Members, PRNewswire, Nov. 23, 2005.

[9] Shareholder Revolt Rocks GenCorp, TMCnet, Apr. 1, 2006.

[10] Marietta Cauch, Jana Partners Sets Energy Bid in Unusual Move for Hedge Fund, Wall St. J., June 13, 2006 (reporting bid by Jana for Houston Exploration).

[11] Hedge Funds Push for Merger of Deutsche Boerse & Euronext, Hedge Fund Street Newsletter, Nov. 23, 2005; Nick Clark & Vivek Ahuja, Hedge Fund Forces Euronext Merger Vote, Financial News Online US, Apr. 14, 2006.

[12] Robert Steyer, Hedge Funds Take Aim at Nabi, The Street.com, April 26, 2006.

[13] ValueAct Refuses to Talk to Chiron about Deal, Wash. Post, Mar. 20, 2006; Shareholder Insurrection Infects Novaritis's $5.1 billion Chiron Bid, Wall St. J., Apr. 3, 2006, at C3.

[14] Gary Norris, Sears Holdings Says it will Own 100% of Sears Canada, CANOE Money, Apr. 7, 2006.

threatened litigation against Delphi;[17] and pushed for litigation against Calpine that lead to the ouster of its top two executives.[18]

Even though most hedge funds are not activist,[19] the ones that are have captured the attention. Martin Lipton, the renowned advisor to corporate boards and veteran of the takeover wars of the 1980s, lists "attacks by activist hedge funds" as the number one key issue for directors.[20] The Wall Street Journal, the newspaper of record for executives, bankers, and investment professionals, calls hedge funds the "new leader" on the "list of bogeymen haunting the corporate boardroom."[21] The Economist runs special reports on Shareholder Democracy focusing on activism by hedge funds.[22] And several European governments are weighing regulations designed to curb activist hedge funds.[23]

What shall we make out of the spate of shareholder activism by hedge funds? Are hedge funds the "Holy Grail" of corporate governance – the long sought-after shareholder champion with the incentives and expertise to protect shareholder interests in the publicly held firm? Or do they represent darker forces, in search for quick profit opportunities at the expense of other shareholders and the long-term health of the economy?

In this Article, we analyze and evaluate the implications of the rise of hedge funds for corporate governance and corporate control. In Part I, we examine and categorize a variety of presumptively "happy stories," that is, examples of different kinds of hedge fund activism where hedge funds have no apparent conflict of interest. We will argue that this hedge fund activism differs, quantitatively and qualitatively, from the more moderate forms of activism that traditional institutional investors engage in.

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[15] Jeff Chappell, Hedge Fund Investors Question Lexar-Micron Deal, EcectronicNews, Apr. 25, 2006.

[16] Jason Singer, Knight Presses VNU Overhaul Plan, Wall St. J., Apr. 7, 2006 at C4.

[17] Jeffrey McCracken, Delphi Ripped for Bankruptcy Case, Wall St. J., Mar. 17, 2006 at A10.

[18] Rebecca Smith, Executives' Ouster Shows Growing Hedge-Fund Clout, Wall St. J., Dec. 1, 2005, at A1.

[19] See infra Section I.C.

[20] Martin Lipton, Wachtell Lipton, Rosen & Katz Client Memo, Dec. 1, 2005; see also Martin Lipton at al., Wachtell Lipton, Rosen & Katz Client Memo, Being prepared for Attacks by Activist Hedge Funds, Dec. 21, 2005 (noting "environment of increased attacks by hedge funds" and advising companies how to deal with it); Martin Lipton at al., Wachtell Lipton, Rosen & Katz Client Memo, Attacks by Activist Hedge Funds, Mar. 7, 2006 (presenting checklist for clients to deal with activist hedge funds).

[21] Alan Murray, Hedge Funds Are New Sheriffs of Boardroom, Wall St. J., Dec. 14, 2005, at A2; see also Jesse Eisinger, Memo to Activists: Mind CEO Pay, Wall St. J., Jan. 11, 2006, at C1 ("The shareholder activists with the most clout these days are hedge-fund managers …").

[22] Battling for Corporate America, The Economist, Mar. 11, 2006 at 69.

[23] Edward Taylor & Alistair McDonald, Hedge Funds Face Europe's Clippers, Wall St. J., May 23, 2006, at C1 (regulations considered by Germany and the Netherlands).

In Part II, we analyze why hedge funds are so much more active than other institutional investors. We show that hedge funds have better incentives, are subject to fewer regulatory impediments and face fewer conflicts of interest than traditional institutions, such as mutual funds and pension funds, who have never lived up to the hopes of their partisans. But the activism of hedge funds may also be due to the fact that they follow a different business strategy than traditional institutions. This strategy involves taking high stakes in portfolio companies *in order to* become activist -- thus blurring the lines between betting on and determining the outcome of contests -- rather than diversifying one's investment and becoming involved (if at all) only *ex post* when companies are underperforming.

In Part III, we turn to potential problems generated by hedge fund activism. We first examine the "dark side" of activism -- instances where the interests of activist hedge funds conflict with those of their fellow shareholders – to see whether regulatory intervention is warranted. We then discuss other problems that arise from the stress that hedge funds put on the governance system.

In Part IV, we turn to the most severe attack leveled against hedge funds: that hedge fund activism increases the pressure for short term results over more valuable long-term benefits. We accept that short-termism by hedge funds can aggravate short-termism in the executive suite. But we nevertheless conclude that at this point no regulatory intervention is warranted because it is unclear to what extent hedge fund activism is driven by excessive short-termism; because hedge funds usually need the support of other, less short-term oriented, constituents to affect corporate policy; and because, to the extent short-termism generates a problem, adaptive devices taken by corporations are a better way to address it than governmental regulation.[24]

I. What's Going on Out There? Some Illustrative (Happy) Stories

Hedge funds are emerging as the most dynamic and most prominent shareholder activists. On the bright side, this generates the possibility that hedge funds will, in the course of making profits for their own investors, help overcome the classic agency problem of publicly held corporations by dislodging underperforming managers, challenging ineffective strategies, and making sure that merger and control transactions make sense for shareholders. In doing so, the bright side holds, hedge funds would enhance the value of the companies they invest in for the benefit of both their own investors and their fellow shareholders. In the first section of this Part, we examine and categorize the different ways in which hedge funds, without any apparent conflicts of interests, have confronted managers demanding changes in management and business strategies or getting involved in corporate control transactions. This section illustrates the potential bright side of hedge fund activism.

[24] We do not address the question of whether additional regulation is needed to protect hedge fund investors from either investment risk or unscrupulous managers. While important and timely, this question is beyond the scope of this article.

But the bright side story of hedge funds – of large and sophisticated investors standing up to management for the benefit of shareholders at large – has an element of déjà vu. Twenty years ago, similar stories were told about another set of large and sophisticated investors: mutual funds, public pension funds, private pension funds, insurance companies, or "institutional investors" as they became called.[25] But while, on the whole, the rise of these traditional institutional investors has probably been beneficial, they have hardly proven to be a silver bullet.

Are there reasons to think that newly prominent hedge funds will be more effective? In section B of this Part, we will start answering this question by comparing the activism of hedge funds to the activism of traditional institutions. We will show that hedge fund activism differs in degree and type from the activism by traditional institutions.

In the final section of this Part, we place hedge fund activism in the context of hedge fund investment strategies more generally. Only a small portion of hedge fund assets are devoted to shareholder activism. Thus, activism does not dominate what hedge funds do. Hedge funds, however, dominate certain modes of activism and – if that activism is profitable and more hedge funds asset become devoted to it – the extent of hedge fund activism could quickly increase.

A. Hedge Funds as Activists

1. Corporate Governance Activism

Hedge funds have increasingly tried to influence the business strategy and management of corporations. This activism takes a variety of forms, from public pressure on portfolio companies to change the business strategy, to the running of a proxy contest to gain seats on the board of directors of portfolio companies, to litigation against present of former managers.

One of the better known (and more entertaining) activist hedge funds is Third Point LLC, which has about $4.0 billion under management.[26] Its list of recent targets includes Ligand, Salton, Western Gas Resources, Massey Energy, Potlatch, Intercept,

[25] *See, e.g.* Bernard S. Black, Agents Watching Agents: The Promise of Institutional Investor Voice, 39 UCLA L. REV. 811 (1991); Black, Shareholder Passivity Reexamined, 89 MICH. L. REV. 520 (1990); Mark J. Roe, A Political Theory on American Corporate Finance, 91 COLUM. L. REV. 10 (1991). But see, e.g. Ronald J. Gilson and Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 STAN. L. REV. 863 (1990); Edward B. Rock, The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79 GEO. L.J. 445 (1991); see also Anat R. Admati et al., Large Shareholder Activism, Risk Sharing, and Financial Market Equilibrium. 102 J. Pol. Econ. 1097 (1994) (developing model of large shareholder monitoring).

[26] James Kelly Joins Third Point As President and Chief Operating Officer, FORBES.COM, Sept. 7, 2005, http://www.forbes.com/prnewswire/feeds/prnewswire/2005/09/07/prnewswire200509070915PR_NEWS_B_MAT_NY_NYW141.html

Warnanco, Penn Virginia and Star Gas Partners L.P.[27] Star Gas, to pick one of the targets, is a heating oil distributor. Third Point acquired around 6% of its units.[28] In addition to severely criticizing CEO Irik Sevin's management of the company, Third Point attacked him personally: "It is time for you to step down from your role as CEO and director so that you can do what you do best: retreat to your waterfront mansion in the Hamptons where you can play tennis and hobnob with your fellow socialites."[29] The governance practices of Star Gas were apparently not ideal. Thus, Third Point openly wondered:

> [H]ow is it possible that you selected your elderly 78-year-old mom to serve on the Company's Board of Directors and as a full-time employee providing employee and unitholder services? We further wonder under what theory of corporate governance does one's mom sit on a Company board. Should you be found derelict in the performance of your executive duties, as we believe is the case, we do not believe your mom is the right person to fire you from your job.[30]

The tactic worked. Bowing to the pressure generated by Third Point, Sevin resigned one month later.[31]

Or take the exploits of Barington, another activist hedge fund. In June 2003, Barington nominated three directors to the board of Nautica Enterprises, the sportswear company. At the time, it held about 3.1 percent of Nautica stock.[32] Shortly thereafter, the company indicated that it was discussing a possible sale.[33] Barington subsequently convinced Institutional Shareholder Services, a proxy voting advisory service, to recommend that its clients vote for the two Barington director nominees.[34] By July 2003, Barington's tactics had worked: Nautica agreed to be acquired by VF Corporation for $587 million[35] and Barington dropped its proxy fight.[36] The following July, Barrington

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[27] Innisfree Presentation to Skadden, Arps, Slate Meagher & Flom LLP, Apr. 23, 2006.

[28] Third Point Demands That Star Gas CEO, Irik Sevin, Resigns and Returns Keys to Company Car, PR NEWSWIRE, Feb. 14, 2005, http://www.prnewswire.com.

[29] Id.

[30] Id.

[31] Ron Orol, Fortress GenCorp, DAILY DEAL, March 25, 2005, http://thedeal.com. Whether this was too little too late is an interesting but separate question. After a brief uptick, Star Gas's stock price continued to decline.

[32] Suzanne Kapner, Board Move Lifts Nautica 21 Percent, N.Y. POST, June 12, 2003, at 41.

[33] Suzanne Kapner, Nautica Rises 11% on News of Suitor, N.Y. POST, June 21, 2003, at 20.

[34] Institutional Shareholder Services Recommends Election of Barington Companies Group Nominees, PR NEWSWIRE, July 2, 2003, http://www.prnewswire.com.

[35] Sundaramoorthy, Nautica Accepts Dollars 587m VF Bid, FINANCIAL TIMES, July 8, 2003, at 26.

[36] Barington Companies Group Reacts Favorably to Proposed Acquisition of Nautica Enterprises by VF Corporation, PR NEWSWIRE, July 7, 2003, http://www.prnewswire.com.

turned to Steven Madden, Ltd., and urged it to explore "strategic discussions with potential acquirers."[37] Barington, which had accumulated a 7.7% stake, sent outside directors a strongly worded letter demanding that it hire a more seasoned CEO, reduce change in control compensation, reduce conflicts of interest on the board, and use its excess cash to buy back shares and pay dividends.[38] By February 2005, the Steve Madden board agreed to spend $25 million in 2005 for share repurchases and/or dividends and to meet with representatives of Barington on a regular basis in order to avoid a proxy fight.[39]

Carl Icahn, familiar to some from the takeover battles of the 1980s, has returned to the headlines by starting a hedge fund, buying blocks in companies and pressuring them to change.[40] Thus, for example, he teamed up with Jana Partners to take a position in Kerr-McGee and push for change. The outcome was a restructuring in which Kerr-McGee sold off its chemicals unit and its North Sea oil fields.[41] He has more recently put pressure on Blockbuster, where he gained three board seats; Time Warner, where the company agreed to add some independent directors to its board and increase the size of its share repurchase program;[42] and KT&G, where the group he led gained board representation.[43]

Other examples, many involving household names, abound. Targets of corporate governance activism thus include McDonalds, where Pershing Square has sought a spin-off of its real estate assets;[44] Wendy's, where Trian Partners has sought an asset spin-off and board seats;[45] Heinz, where Trian has nominated 5 directors to the 12 member board;[46] Pep Boys Manny, Moe & Jack, where Barington has sought to induce the

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[37] Tania Padgett, A Proxy Fight is Brewing for Steven Madden, NEWSDAY (N.Y.), Dec. 30, 2004, at A45.

[38] Barington Capital Group Sends Letter to Outside Directors of Steven Madden Ltd., PR NEWSWIRE, Dec. 13, 2004, http://www.prnewswire.com.

[39] Steven Madden, Ltd., and the Barington Capital Group Reach Agreement, PR NEWSWIRE, Feb. 2, 2005, http://prnewswire.com.

[40] Susan Pulliam, Once a Lone Wolf, Carl Icahn Goes Hedge-Fund Route, Wall St. J., Aug. 12, 2005, at A1.

[41] Greg Johnson, News in brief, The Daily Deal, March 4, 2005; Patricia Koza, " Kerr pursues revamp," The Daily Deal, August 9, 2005.

[42] Matthew Karnitschnig, Time Warner, Icahn Reach Accord – Firm to Step Up Buybacks, Cost Cutting as Investor Ends Bid for Board Seats, Wall St. J., Feb. 18, 2006, at A3.

[43] See supra note 6.

[44] See supra note 2.

[45] James Politi, Wendy's Agrees with Trian, Fin. Times, Mar. 3., 2006, at 15.

[46] Janet Adamy, Heinz Investors to Seek Board Seats, Wall St. J., Apr. 25, 2006, at A17 .

company to sell itself or replace its CEO;[47] and Delphi Corp., where Appaloosa Management has sought board seats and the creation of (and representation on) and official equity committee to represent shareholder interests in the company's Chapter 11 proceeding. [48]

In the course of their general corporate governance activities, hedge funds often get involved in various legal disputes with the targets of their activism. While these disputes are usually an adjunct to broader activism – as when Jana Partners sued SourceCorp. to invalidate changes in the company's by-law in light of an impending proxy contest[49] or when Mason Capital tried to block the recapitalization of Kaman arguing that it violated the Connecticut anti-takeover statute[50] -- litigation is sometimes an essential part of the activist strategy. Take, for example, Cardinal Value Equity Partners, which owned about 1.5 million shares in Hollinger International. When allegations about self-dealing and other improper transactions by Conrad Black, Hollinger's CEO, and other members of Hollinger's management started to circulate, Cardinal brought a lawsuit in Delaware to obtain records and corporate documents.[51] Six months later, in December of 2003, Cardinal brought a derivative lawsuit for breach of fiduciary duty against Hollinger's board of directors.[52] Cardinal's action was stayed to permit an independent board company to investigate the alleged misconduct.[53] By May of 2005, Cardinal had negotiated a $50 million settlement with the directors not directly implicated in the self-dealing, with Hollinger pursuing the self-dealing claims against

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[47] Suzanne McGee, US Shareholder Friendly Rankings, Institutional Investor Magazine, Apr. 14, 2006.

[48] Jeffrey McCracken, Delphi Ripped for Bankruptcy Case, Mar. 17, 2006 at A10; see also Karen Richardson, New Way to Play Distressed Firms: Acquire the Stock, Wall St. J., May 1, 2006, at C1.(reporting that Xerion Capital helped form a equity committee in chapter 11 which succeeded in increasing the sale price of Riverstone Networks's assets from $170 to $210 million). For other instances of hedge fund governance activism, see Alan Murray, Backlash Against CEOs Could Go Too Far, WALL ST. J., June 15, 2005, at A2 (noting that hedge funds ratcheted up pressure on Morgan Stanley board to remove CEO); Henny Sender, Hedge Funds: The New Corporate Activists, WALL ST. J., May 13, 2005, at C1 (noting hedge fund activism at OfficeMax, Woolworths, and Wendy's); Knight Ridder Goes Up for Sale, But a Bidding Was in Unlikely, Wall St. J., Nov. 15, 2005, at A3 (noting that Knight Ridder, under pressure from Private Capital Management, a hedge fund and the company's largest shareholder, put itself up for sale);. Steel Partners Asks Board of BKF Capital to Redeem Poison Pill, PR NEWSWIRE, Dec. 16, 2004, http://www.prnewswire.com (discussing activism by Steel partners in BKF); Steel Partners Serves Notice to BKF Capital Group, Inc, PR NEWSWIRE, Feb. 14, 2005, http://www.prnewswire.com (same).

[49] Jana Partners Sues Sourcecorp, Dallas Business Journal , July 6, 2005.

[50] Judge Rules in Favor of Kaman's Proposed Recapitalization; Enjoins Closing Until December 1, PR Newswire, Oct. 31, 2005; Kaman and Mason Agree to End Litigation Concerning Recapitalization, PR Newswire, Nov. 3, 2005.

[51] Liz Vaughan-Adams, The Independent, July 9. 2003 at 19.

[52] Jim Kirk, Chicago Tribune, Jan. 3, 2004, at C1 (lawsuit filed on December 10, 2003).

[53] Dominic Rushe, Sunday Times, Jan. 4, 2004, at 1.

Black and some of his associates in a separate litigation.[54] Cardinal, moreover, keeps pressuring Hollinger's board and recently criticized its failure to remove some of the settling directors from its ranks.[55]

Tellingly, hedge funds have even sought appointment as lead plaintiffs in securities fraud class actions under the Private Securities Litigation Reform Act. What makes these efforts noteworthy is that, even though hedge funds are often among the investors with the largest losses, their appointment as a lead plaintiff is fraught with problems. Because hedge funds often engage in short selling, they face issues of reliance that may render them "inadequate" class representatives. A short strategy is based on the assumption that the current market price is inaccurate. This provides evidence that a short-selling hedge fund did not rely on the integrity of the market price, as required under the fraud on the market theory on which most securities fraud class actions are based. Indeed, courts have often,[56] though not uniformly, [57] rejected the appointment of hedge funds as lead plaintiff on that basis.[58]

2. Corporate Control Activism

Hedge funds have been particularly active in transactions involving potential changes in corporate control. This activism broadly falls into three categories. First, as shareholders of the acquirer or a proposed corporate control transaction, hedge funds

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[54] Hollinger Int'l. Announces Settlement by Certain of its Current and Former Independent Directors of Claims asserted in Derivative Action Filed by Cardinal Value Equity Partners, L.P., Canada NewsWire, May 3, 2005.

[55] Richard Siklos, Rebuked, Even Sued, a Board Remains in Place, N.Y. Times,, Sep. 26, 2005, at C1. See also Cardinal Value Sues InfoUSA CEO, Yahoo! Finance, Feb. 24, 2006; In re Pure Resources Shareholder Litigation, 2002 Del. Ch. Lexis 116 (other cases where Cardinal engaged in litigation).

[56] In re Bank One Shareholders Class Actions, 96 F. Supp. 2d 780 (N.D. Ill. 2000) (court rejected a hedge fund as lead plaintiff who "engaged in extensive daytrading, first shorting Bank One stock, presumably because it was regarded as overvalued at market price, and then buying to cover the short position."): Camden Asset Management, L.P., et al. v. Sunbeam Corp., et al., 2001 U.S. Dist. LEXIS 11022 (S.D. Fla. 2001) (class action brought by hedge fund that hedged its investment in convertible debentures not certified because individual issues of reliance held to predominate); In re Critical Path, Inc., Securities Litigation, 156 F. Supp. 2d 1102 (N.D.Calif. 2001) (hedge fund which shorted stock held to be inadequate class representative in fraud on the market class action because short strategy is premised on inaccuracy of current market price).

[57] In re Tyson Foods, Inc., Securities Litigation, 2003 U.S. Dist. LEXIS 17904 (D.Del. 2003) (hedge funds held to be adequate class representatives in securities fraud class action); Danis v. USN Communications, Inc., 189 F.R.D. 391, 396 (N.D. Ill. 1999) (rejecting challenge to class representative's typicality based on short sales, because class representative also lost money on long positions; acknowledging that short selling may be inconsistent with fraud-on-the market theory)

[58] In an interesting development, Chancellor Leo Strine forced a hedge fund to serve as a defendant class representative in Regal Entertainment Group v. Amaranth, LLC, 894 A.2d 1104 (Del. Ch. 2006). The effect of this – and presumably why the hedge fund resisted – is that any settlement must be approved by the court and, moreover, as class representative cannot settle separately.

have tried to prevent the consummation of the transaction. Second, as shareholders of the target of a proposed control transaction, hedge funds have tried to block the deal or improve the terms for target shareholders. Third, hedge funds have themselves – sometimes on their own, sometimes as part of a group – tried to acquire companies.

a. Blocking Acquirers

Perhaps the best-known example of a hedge fund blocking an acquirer involves the proposed acquisition by Deutsche Boerse (DB) of the London Stock Exchange (LSE). Having tried and failed to acquire LSE in 2000, DB announced a new acquisition bid in December 2004.[59] This quickly spurred Euronext, a competing exchange, to announce its interest in LSE.[60]

DB's problems started when, in mid-January, The Children's Investment Fund Management (TCI),[61] a London-based hedge fund which had assembled more than a 5% stake, announced its opposition. TCI argued that using DB's cash hoard to buy back shares "would be far superior in value creation."[62] Although the bid did not require shareholder approval, TCI held a large enough stake to call an extraordinary general meeting to dismiss DB's supervisory board.[63] Around the same time, Atticus Capital, a US-based fund which then controlled around 2% of DB's shares, joined TCI in opposing the bid.[64] Prompted by TCI and Atticus, by February, DB shareholders holding about 35% of its stock (including several mutual funds) were planning to confront DB.[65] TCI started looking for a candidate to replace Rolf Breuer as DB's chairman, and came up

[59] Norma Cohen, Jeremy Grant & Patrick Jenkins, LSE in the Bid Spotlight, FINANCIAL TIMES (London), Dec. 14, 2004, at 23.

[60] Norma Cohen, LSE War Looms as Euronext Confirms Intent, FINANCIAL TIMES (London), Dec. 21, 2004, at 22.

[61] So named because half of TCI's annual management fee of 1 percent is paid to The Children's Investment Fund Foundation. Martin Waller, Fund Says Opposition to Borse's LSE Bid is Mounting, TIMES (London), Jan. 18, 2005, at 43.

[62] Richard Wray, Borse Rebel Threatens to Derail LSE Bid: Investor's Call for Return of Cash May Block German Move, GUARDIAN (London), Jan. 17, 2005, at 21.

[63] To call a meeting, TCI would have to register its share with BaFin and hold them for 3 months. Damian Reece, Borse Could Bid Pounds 1.7 bn for LSE, Says Deutsche, INDEPENDENT (London), Jan. 27, 2005, at 48.

[64] Norma Cohen, Deutsche Borse's 'Empire Building', FINANCIAL TIMES (London), Jan. 17, 2005, at 19.

[65] Louise Armitstead, Shareholders Revolt in Bid to Topple Seifert, SUNDAY TIMES (London), Feb. 20, 2005, at Business 1; Julia Kollewe, Fidelity Joins D Borse Shareholder Revolt, INDEPENDENT (London), Feb. 25, 2005, at 37 (indicating that Fidelity held more than a 4.5 percent stake).

with Lord Jacob Rothschild, who, as it happens, is the father of one of the Atticus partners.[66]

In early March, DB's CEO Seifert came to London to meet with the largest dissident shareholders. They refused.[67] With more than 40 or 50% or even 60% of the shares opposing the bid, depending on reports, DB abandoned its bid in early March and promised to develop a plan to distribute the cash.[68] In celebrating the victory, the division of labor between hedge funds and traditional institutional investors became clear, "One institution said: 'The hedge funds have done a marvelous job. No matter how we feel about companies, traditional managers simply cannot move as fast to achieve our aims. We were right behind (the hedge funds), but we couldn't have done it without them.'"[69] In May 2005, Seifert resigned after having been ordered by the supervisory board "to change the composition of both the supervisory and executive boards in order to reflect the new ownership structure of the company."[70]

Other instances where hedge funds as shareholders of acquirers have sought to block an acquisition include Carl Icahn's efforts to prevent Mylan Laboratories from acquiring King Pharmaceuticals;[71] Knight Vinke, which followed Templeton is opposing VNU's proposed acquisition of IMS Health;[72] Duquesne Capital Management, which opposed the proposed acquisition of Public Service Enterprise Group by Exelon;[73] OrbiMed Advisors, which succeeded in blocking the acquisition of EOS by Pharmacopia;[74] and Pirate Capital, Omega Advisors, and Jana Partners, who oppose Mirant's offer to acquire NRG.[75]

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[66] Louise Armitstead, *Rothschild to Lead Battle for Borse Rebels*, SUNDAY TIMES (London), Feb. 27, 2005, at Business 1; Grant Ringshaw, *Rothschilds Unite in Attack on Seifert*, SUNDAY TELEGRAPH (London), Feb. 27, 2005 at City 1.

[67] Deutsche Boerse Bows to the might of Investment Funds, FT Global Newswire, Mar. 7, 2005.

[68] Id.; Norma Cohen & Patrick Jenkins, Shareholder Rebellion Puts Paid to Borse Chief's Vision, FINANCIAL TIMES (London), Mar. 7, 2005, at 30; Danny Fortson, Deutsche Borse Drops LSE Hunt, DAILY DEAL, Mar. 8, 2005, http://www.thedeal.com.

[69] Louise Armitstead, Saved by the Growing Power of Hedge Funds, SUNDAY TIMES (London), Mar. 13, 2005, at Business 14.

[70] Werner Seifert Resigns As Deutsche Boerse CEO, Wall St. J., May 9, 2005, Wall St. J., May 9, 2005.

[71] See infra Section III.A.3.

[72] Dennis K. Berman & Jason Singer, The Buzz: VNU's Largest Shareholders Deride Plan to Buy IMS Health, Wall St. J., Oct. 1, 2005, at B3.

[73] Exelon Merger Criticized, Chicago Tribune, May 13, 2006.

[74] Pharmacopia and Eos Call off Merger, San Francisco Business Times, Jan. 18, 2002.

[75] Emma Trincal, Mirant Up on Activist Agitation, The Street.com, June 21, 2006.

b. Blocking Targets

As shareholders of target companies, hedge funds have actively opposed several proposed acquisitions and often succeeded in improving the terms of the transaction. A recent example involves Novartis' attempt to acquire the 58% of Chiron that it did not already own. Novartis initially offered $40 per share for the Chiron shareholders. An independent committee of Chiron negotiated this price up to $45 per share, a 23% premium over Chiron's pre-offer share price.[76] One month after the agreement was announced, ValueAct Capital, a hedge fund and the third largest shareholder of Chiron, sent a stinging letter to Chiron's CEO announcing its opposition. This started a shareholder revolt with mutual fund Legg Mason, the second largest shareholder of Chiron, joining ValueAct's opposition and Institutional Shareholder Services recommending a vote against the deal.[77] To get the transaction through, Novartis had to raise its offer to $48 a share,[78] increasing the premium from 23% to 32%.

The fate of the Chiron-Novartis deal is not unusual. Other examples of hedge funds opposing acquisitions include Masonite International, where Eminence Capital and Greystone Management Investment succeeding in raising the price from C$40.20 to C$42.25;[79] ShopKo, where Elliott Management derailed a proposed acquisition for $24 a share;[80] MONY, where Highfields led the opposition to its acquisition by AXA;[81] Molson, where Highfields forced Coors to improve the sale terms;[82] VNU, where Knight Vinke Asset Management opposes its acquisition by a consortium of private equity firms;[83] Lexar Media, where Carl Icahn and Elliott Associates oppose the merger with Micron; Sears Canada where Pershing Square tried to hold out against a bid by Sears (itself a company run by hedge fund manager Eddie Lampert) to freeze-out the minority shareholders;[84] Titan International, where Jana Partners thwarted its proposed acquisition

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[76] Novartis Announces Agreement to Acquire Remaining Stake in Chiron, Press Release, Nov. 2, 2005

[77] David P. Hamilton, Shareholder Insurrection Infects Novartis's $5.1 Billion Chiron Bid, Wall St. J., Apr. 3, 2006, at C3.

[78] David P. Hamilton, Novartis Raises Chiron Bid, Virtually Sealing Deal, Wall St. J., Apr. 4, 2006, at A2.

[79] See Eminence Capital Presents Letter to Masonite Board of Directors, CANADA NEWSWIRE, Jan. 27, 2005, http://www.newswire.ca; *Masonite Shareholders Approve Proposed Acquisition by KKR*, CANADA NEWSWIRE, Mar. 31, 2005, http://www.newswire.ca.

[80] ShopKo Agrees to $29 a Share Offer from Sun Capital, Business Journal of Milwaukee, Oct. 18, 2005.

[81] See infra Section III.A.2.

[82] Innisfree Presentation, supra note 27.

[83] See supra note 16.

[84] See supra note 14.

by a private equity firm;[85] and MCI, which faced a threat of a proxy contest by Deephaven Capital to derail its acquisition by Verizon.[86]

When hedge funds are dissatisfied with the terms of an acquisition and unable to obtain better terms, they have also resorted to litigation. In particular, hedge funds have filed statutory appraisal actions, in which shareholders receive a court-determined fair value instead of merger consideration. Take the acquisition of Emerging Communications (ECM) by its majority-shareholder Innovative Communications Corp. for $10.25 per share.[87] Greenlight Capital, a hedge fund, held about 500,000 shares in the company. After the acquisition was announced, it increased its stake and sought appraisal for 750,300 shares.[88] As is common-place in minority freeze-out mergers, a plaintiff's law firm had also filed a fiduciary duty action.[89] These actions are often settled for a relatively modest recovery (if any).[90] But when a settlement providing for no additional payments to shareholders but for $100,000 in legal fees was proposed,[91] Greenlight, which had also acquired litigation rights for over 2 million ECM shares, objected.[92] Both the appraisal and the fiduciary duty action proceeded to trial, and the court determined that the fair value of an ECM share was $38.05. Greenlight was awarded that amount, plus compounded interest, on its appraisal shares and damages of $27.80 per share – the difference between the fair value and the merger consideration – in the fiduciary duty action.[93]

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[85] Titan International, Inc. Announces Termination of Proposed Buyout, Business Wire, Apr. 21, 2006.

[86] See Dennis K. Berman & Almar Latour, Major MCI Holder Starts Proxy Fight to Thwart Verizon, WALL ST. J., June 15, 2005, at B3 (noting possible proxy fight by Deephaven Capital Management against Verizon-MCI merger); see also Jason Singer, With Rising Clout, Hedge Funds Start to Sway Mergers, WALL ST. J., Jan. 25, 2005, at A1 (reporting several instances where hedge funds interfered with acquisition bids).

[87] *In re* Emerging Commc'ns, Inc. S'holders Litig., 2004 Del. Ch. LEXIS 70, at *3, 2004 WL 1305745, at *1 (Del. Ch. May 3, 2004, revised June 4, 2004).

[88] Greenlight had held shares in ECM before the merger was announced, but increased its stake by 264,700 shares between the announcement and the merger vote. In its 13D filed 10 days later, Greenlight disclosed that it intends to seek appraisal rights. *See* Greenlight Capital, L.L.C., General Statement of Acquisition of Beneficial Ownership (Form 13D) (Sept. 28, 1998).

[89] In re Emerging Commc'ns, 2004 Del. Ch. LEXIS 70 at *3, 2004 WL 1305745, at *1.

[90] See In re Cox Commc'ns, S'holders Litig., 879 A.2d 604, 622 (Del. Ch. 2005); Elliott J. Weiss & Lawrence J. White, File Early, Then Free Ride: How Delaware Law (Mis)Shapes Shareholder Class Actions, 57 Vand. L. Rev. 1797 (2004).

[91] Brickell Partners v. Prosser, Stipulation and Agreement of Compromise and Settlement, June 27, 2000.

[92] In re Emerging Commc'ns, 2004 Del. Ch. LEXIS 70 at *3, 2004 WL 1305745, at *1.

[93] In re Emerging Commc'ns, 2004 Del. Ch. LEXIS 70 at *155, 2004 WL 1305745, at *43. Emerging has appealed the judgment to the Delaware Supreme Court where the case is presently pending. See also Prescott Group v. The Coleman Co., 2004 Del. Ch. LEXIS 131 (awarding dissenting shareholders of Coleman who sought appraisal, which included hedge fund, $32 a share).

Other instances of hedge funds exercising appraisal rights include Gabelli Asset Managements's 2004 appraisal action against Carter Wallace,[94] Prescott Group's appraisal against Coleman,[95] and the pending appraisal action brought by Icahn and others in Transkaryotic Therapies, where hedge funds had tried but failed to block the acquisition and decided to pursue appraisal instead of accepting the merger consideration.[96]

c. Making Bids

Unlike traditional institutional investors, hedge funds not only urge portfolio companies to be acquired by others, but have themselves made attempts to acquire these companies. These bids can be part of a strategy to improve the governance or capital structure of these companies or to put the target in play. In other instances, however, hedge funds have emerged as controlling shareholders of large industrial corporations.

As an example of an acquisition offer that induced corporate governance changes, consider GenCorp. GenCorp owned more than 12,000 acres of undeveloped land in Sacramento, a holding that attracted the interest of various investors.[97] In November, 2004, Steel Partners (a hedge fund) announced that it was interested in acquiring GenCorp for $17 per share.[98] When the board rejected Steel Partner's advance, it threatened a proxy contest.[99] By February, 2005, GenCorp had entered into an agreement according to which Steel Partners would cast its votes in favor of GenCorp's nominees in exchange for which a representative of Steel Partners could attend board meetings; and the board would appoint a new independent director expert in corporate governance identified in consultation with Steel Partners; and the board would then consider corporate governance changes proposed by Steel Partners.[100]

Next consider ShopKo, a retail and pharmacy store chain. ShopKo had agreed to be acquired by Golder Hawn, a private equity firm, for $24 per share. But Elliott

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[94] Press Release, Gabelli Clients Realize a More Than 40% Premium in Settlement of Carter-Wallace Appraisal Litigation, Nov. 1, 2004.

[95] Prescott Group v. Coleman Co., 2004 Del. Ch. Lexis 131.

[96] Latham and Watkins, Hedge Fund Activist M & A Investing, 2006 Proxy Season Symposium (on file with authors).

[97] Gene G. Marcial, GenCorp's Earthly Assets, BUS. WK., Jan. 24, 2005, at 100.

[98] Steel Partners Offers to Acquire the Outstanding Shares of GenCorp Inc. in Letter to Board, PR NEWSWIRE, Nov. 11, 2004, http://www.prnewswire.com.

[99] Ron Orol, GenCorp Rejects $700M Offer, DAILY DEAL, Nov. 16, 2004, http://www.thedeal.com.

[100] Dale Kasler, GenCorp Reaches Truce with Firm that Made Hostile Bid, SACRAMENTO BEE, Feb. 17, 2005, at D1.

Associates, a hedge fund with a major stake in ShopKo, opposed the proposed deal. Together with Sun Capital, a private equity firm, and some other investors, Elliott made a counter bid of $26.50. After an auction, the Elliott group succeeded in acquiring ShopKo for $29 a share.[101]

Finally, take Kmart. Kmart had filed for bankruptcy in February 2002. When it emerged from Chapter 11 in May 2003,[102] its largest shareholder was the hedge fund ESL, run by Edward Lampert. ESL owned about 50% of the company, having acquired $2 billion in financial claims (for somewhere around $200 million) which were then converted into stock in the reorganization.[103] At the time Kmart emerged from bankruptcy, its stock opened at $15 per share and drifted downwards. But by July 2004, Kmart's stock was at $76 per share and Lampert, who had taken over the management of Kmart, was the toast of the town.[104] By unlocking the value of Kmart's real estate through selling off stores, Kmart accumulated a $2.2 billion "cash hoard."[105] By November 2004, Lampert answered the market's question of what he was going to do with all that money: Kmart and Sears agreed to merge.[106] The news of the deal pushed Kmart stock up to $109 per share, with Sears shares rising as well.[107]

Additional examples of hedge funds making bids include Appaloosa Management, which made a bid for Beverly Enterprises;[108] Highfields, which made a bid to acquire Circuit City;[109] ValueAct, which is trying to acquire Acxiom, [110] and Jana Partners, which made a bid for Houston Exploration.[111]

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[101] ShopKo Agrees to $29 a Share Offer from Sun Capital, Business Journal of Milwaukee, Oct. 18, 2005.

[102] Which is very quick for a major bankruptcy, and explained by the incentives put in place for management. See Douglas G. Baird & Robert K. Rasmussen, Reply, Chapter 11 at Twilight, 56 STAN. L. REV. 673 (2003).

[103] Week in Review, CRAIN'S DETROIT BUS., May 12, 2003, at 34; Christopher Byron, Short-Sell Scramble; Investors are Betting That Kmart Won't Bounce Back, N.Y. POST, May 19, 2003, at 37.

[104] Becky Yerak, Exec Lifts Kmart's Stock into Blue Yonder, CHI. TRIB., July 11, 2004, at C1.

[105] Robert Berner, Turning Kmart into a Cash Cow, BUS. WK., July 12, 2004, at 81,.

[106] Constance L. Hays, Kmart Takeover of Sears is Set, N.Y. TIMES, Nov. 18, 2004, at A1.

[107] Id. ESL had owned a large block of Sears stock since before its investment in Kmart, a block which had increased to 15% by the time the merger was announced. Merger at the Mall; Kmart and Sears Merge, ECONOMIST.COM, Nov. 18, 2004, http://www.economist.com.

[108] Peter Moreira, Four Funds Bid for Beverly, DAILY DEAL, Jan. 27, 2004, http://www.thedeal.com. In response to the bid, the board of Beverly decided to auction the company, which was ultimately acquired by another bidder. Peter Loftus, Beverly Enterprises to be Acquired By Investor Group for $1.63 Billion, Wall St. J., Aug. 18, 2005, at A6; Beverly Enterprises Receives Higher Bid, Wall St. J., Aug. 22, 2005, at C5; Peter Loftus, Beverly Enterprises Agrees to Bid By Fillmore Despite Better Offer, Wall St. J., Nov. 22, 2005, at C4.

[109] Michael Barbaro, Circuit City Rejects Hedge Fund's Cash Bid, Washington Post, Mar. 8, 2005 at E05; Gary McWilliams, Circuit City Rejects Takeover Bid, Won't Consider Any Other Offers, WALL ST. J.,

B. Activism by Traditional Institutions Compared

Over the last 20 years, traditional institutional investors – specifically public pension funds and mutual funds – have also engaged in shareholder activism. The mode of this activism, however, differs in important respect from the activism by hedge funds.

Activism by traditional institutions falls for the most part in two categories. Starting in the mid-1980s, and continuing to a limited extent until today, traditional institutions have made shareholder proposals under Rule 14a-8. These proposals are usually precatory resolutions that relate to various aspects of the corporate governance rules, such as poison pills, confidential voting, and board structure. Most of these proposals were introduced by a set of public pension funds – including CalPERS, various New York pension funds, and the State of Wisconsin Investment Board – and by TIAA-CREF.[112] Since the mid-1990s, institutions have increasingly engaged in private negotiations to get boards to make governance changes voluntarily and have resorted to formal proposals in some of the instances where boards failed to do so.[113]

Seeking governance changes through (actual or threatened) shareholder proposals has largely been the domain of public pension funds.[114] Other than TIAA-CREF, mutual funds have not themselves been active in introducing proposals, whether initially or after failed private negotiations. Mutual funds have, however, voted in favor of proposals introduced by others. In addition, mutual funds have adopted policies to vote against certain changes in governance rules that entrench the current board if such changes are

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Mar. 8, 2005, at A8 (reporting bid by hedge fund Highfields for Circuit City and reporting increasing interest by hedge funds in pursuing takeovers).

[110] ValueAct Redoubles Acxiom Takeover Effort, Direct, Oct. 4, 2005.

[111] Marietta Cauch, Jana Partners Sets Energy Bid in Unusual Move for Hedge Fund, Wall St. J., June 13, 2006 (reporting bid by Jana for Houston Exploration).

[112] See, e.g., Stuart L. Gillan & Laura T. Starks, Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors, 57 J. Fin. 275 (2000) (presenting data of proposals); Diane Del Guercio & Jennifer Hawkins, The Motivation and Impact of Pension Fund Activism, 52 J. Fin. Econ. 293 (1999) (same); Michael P. Smith, Shareholder Activism by Institutional Investors: Evidence from CalPERS, 51 J. Fin. 227 (1996) (same); Jonathan M. Karpoff et al., Corporate Governance and Shareholder Initiatives: Empirical Evidence, 42 J. Fin. Econ. 365 (1996) (same).

[113] Carleton et al., The Influence of Institutions on Corporate Governance through Private Negotiations: Evidence from TIAA-CREF, 53 J. Fin. 1335 (1998); Gillen & Starks, supra note 112, at 279; Stuart L. Gillan & Laura T. Starks, Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective, J. Appl. Corp. Fin. 4, 10, Fall/Winter 2003.

[114] More recently, union-affiliated pension funds increasingly sponsor shareholder proposals.

proposed by the board of directors and sometimes withhold votes (i.e., abstain) in the election of directors.[115]

These activities differ from activism by hedge funds in a variety of ways. They are directed to changes in the corporate governance *rules*, rather than to specific aspects of a company's business or management (such as share buy-backs, spin-offs, mergers, or the composition of the board of directors). The effect of the policy changes sought is usually minor, either because the subject matter is not very important,[116] because the shareholder resolution is precatory (and a favorable vote is thus not binding), or because a board, even if it agrees to adopt the proposed policy, is free to change it at a later point of time. To the extent that the "activism" takes the form of merely voting in favor of proposals by others (or against proposals made by the company's board), it represent a rather passive form of "activism." Finally, a group of portfolio companies tend to be targeted at the same time[117] and often with respect to the same governance changes. Viewed charitably, this mode of activism is designed to achieve small changes in multiple companies at little expense, but is unlikely to result in big changes in specific companies. The prominent role of proxy advisory firms like Institutional Shareholders Services (ISS) is consistent with this focus on small, low cost, systemic changes.

The second category of activities by traditional institutions consists of "behind the scenes" discussions with company management and board members.[118] From what has become known about these activities after the fact, it appears that they seek the same modest changes in governance rules as do shareholder proposals. For example, Carleton, Nelson and Weisbach, who obtained access to the private correspondence between TIAA-CREF and firms, report that the changes sought involved confidential voting, board diversity, and limitations on targeted stock placements.[119] Known instances of institutions seeking more far reaching changes are rare and often involve unusual fact patterns.[120]

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[115] See Roberta Romano, Public Pension Fund Activism in Corporate Governance Reconsidered, 93 Colum. L. Rev. 795, 834 (1993). Public pension funds, though not mutual funds, have also applied to become lead plaintiff in securities fraud class actions. Securities fraud class actions, however, are at the periphery of corporate governance and control activities.

[116] Roberta Romano, Does Confidential Voting Matter?, 32 J. Legal Stud. 465 (2003)(concluding that confidential voting proposals are immaterial).

[117] See Press Release, CalPERS Focus List Targets Six Underperfroming Companies, Apr. 19, 2006.

[118] Carleton, supra note 113, Gillan & Starks, supra note 113, at 10.

[119] Carleton et al., supra note 113, at 1343 – 48; see also Allen Myerson, The New Activism at Fidelity, N.Y. Times, Aug. 8, 1993, at 15 (noting letter opposing certain pay plans that Fidelity sent to 100 companies). See also Alan Murphy, At AIG, a First Glance at 'Good Governance', Wall St. J., May 17, 2006, at A2 (noting that public pension funds induced governance changes such as separating the posts of chairman and CEO, increasing the number of independent board members, and requiring independent directors to meet in 'executive session').

[120] Gillan and Starks, for example, report that Fidelity had one of its employees appointed as CEO of Colt Telecom. Gillan & Starks, supra, note 113. But Colt was unusual in that it was founded by Fidelity, was

As to the activities that have remained non-public, we of course do not know their full scale and scope. But we consider it unlikely that such activities resemble the activism of hedge funds. That institutions often succeed in achieving major changes through behind the scenes discussions without their efforts to do so sometimes becoming public is implausible.[121] After all, if management is not receptive to the proposed changes, the institution must either give up or go public. And if management knows that institutions are reluctant to go public, they have little incentive to accede to the request for change. Moreover, the leverage that institutions can exercise behind the scenes is limited. If an institution wanted to coordinate its pressure with those of other institutions, it may become engaged in a solicitation or in the formation of a "group," which would often require a public filing.[122] The scarcity of such filings and the absence of any reports to the contrary, suggest that traditional institutions do not coordinate their "behind the scenes" pressure. We are skeptical whether uncoordinated pressure by a single institution will often result in meaningful change.

This being said, traditional institutions have recently, in the wake of hedge fund activism, become somewhat more active in matters involving corporate control. Thus, as discussed above, Franklin Mutual Advisers, an investment adviser for mutual funds and other accounts, has joined forces with a hedge fund and other investors in making a bid for Beverly Enterprises; and mutual funds have supported the efforts of hedge funds to block the acquisition of the London Stock Exchange by Deutsche Bank, of Chiron by Novartis, of MONY by AXA, and of IMS Health by VNU.[123] And we suspect that here are additional examples where traditional institutions have expressed support for hedge funds in private communications with management. Hedge funds, it thus appears, have not just been activist themselves; they have also been a catalyst for activism by traditional institutions conducted jointly with, or in the wake of, hedge funds.[124]

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close to bankruptcy , and Fidelily held 54% of its stock. See Colt Names Fidelity's Akin to Replace CEO Maning, Boston Bus. J., July 24, 2002.

[121] Cf. Leon Lazaroff, Hedge Fund Activist Turn up Heat, Chicago Tribune, Nov. 27, 2005 (quoting investor as saying that mutual funds rarely press underperforming companies to change); Jill Fisch, Relationship Investing: Will it Happen? Will it Work?, 55 Ohio St. L. J. 1008, 1030 (1994).

[122] See Securities Exchange Act of 1934, Sections 13(d) and 14(a). By contrast, hedge funds, by conducting their activism in public, reduce the need for express coordination. See also Section III.B.1.

[123] This kind of activism is relatively novel for mutual funds. See Ann Carrns, Putnam Cites Price in Plan to Vote Against WaMu's Providian Deal, Wall St. J., Aug. 2. 2005, at C3 (quoting bank analyst as describing public opposition by a mutual fund to acquisition as "a little bit unusual").

[124] See generally Wachtell, Lipton, Rosen & Katz, Shareholder Activism in the M&A Context, Client memo, May 15, 2006 ("even traditional long-term institutional investors are on occasion becoming more outspoken than they have in the past. The fusion of aggressive hedge fund activism and the power of large institutional holders is a potent formula that can energize an activist campaign."). The willingness of traditional institutions to become involved in activism with hedge funds may be enhanced by the adoption of Reg. FD, which made it harder for management to retaliate against institutional investors by engaging in selective disclosure of information. Black, supra note 25, at 601.

C. Hedge Fund Activism in Perspective

In assessing the many instances where hedge funds have adopted an activist posture in corporate governance and control transactions, one has to keep in mind that only a minority of hedge funds pursue shareholder activism. Some hedge funds do not own many equity securities because they pursue macroeconomic strategies or because they invest primarily in debt securities. And even most hedge funds that focus on equity securities are not activist – because they pursue quantitative strategies, because they value their relationship with management, or for other reasons.[125] Indeed, according to a recent estimate by J.P. Morgan, only 5% of hedge fund assets, or about $50 billion, are available for shareholder activism.[126]

Our point in discussing hedge fund activism is thus not that shareholder activism is predominant among hedge funds. It is not. Our point is rather that hedge funds – to the virtual exclusion of traditional institutional investors -- dominate certain modes of shareholder activism. The fact that only a minority of hedge funds engage in such activism makes this point, if anything, even more noteworthy.

But the fact that, at present, only a minority of hedge funds are engaged in shareholder activism is important for another reason as well. It indicates that there is a large untapped fund of money that could quickly become available for activism. If activist strategies are profitable, and more so than the other investment strategies hedge funds pursue, it would not take much for the capital devoted to activism to double or even quadruple overnight.[127] Thus, whatever the extent of hedge fund activism today, it can become much larger – or much smaller – tomorrow.

II. Hedge Funds as Institutional Investors

The activities of hedge funds described in Part I give substance to the hope that hedge funds may act "like real owners" and provide a check on management discretion. But similar hopes were generated in the 1980s when commentators noted that a significant shift in the shareholder profile of public corporations -- from small individual

[125] See, e.g., Richard Dobbs & Timothy Koller, Inside a Hedge Fund: An interview with the Managing Partner of Maverick Capital, McKinsey on Finance 6, 9-10, Spring 2006 (explaining that hedge fund avoids public disputes with management and will sell stock if board does not respond to suggestions for change). See generally The Barclay Group, Hedge Fund Industry – Assets Under Management, at www.barclaygrp.com/indices/ghs/HF_Money_Under_Management.html (chart of money under management by hedge fund strategy).

[126] J.P.Morgan, Global Mergers and Acquisitions Review, at 89.

[127] Unlike mutual funds, which have to abide by the investment policies described in their registration statement or obtain shareholder approval for a change (see Investment Company Act, sec. 8(b)(2)), hedge funds can quickly change their policies to respond to new profit opportunities.

shareholders to large institutional holders -- had taken place.[128] The rise of institutional investors generated, starting in the early 1990s, a series of articles analyzing the corporate governance implications of institutional shareholdings.[129]

In this Part, we analyze hedge funds against the backdrop of the analysis of traditional institutional investors. Our comparison will focus on open-ended mutual funds, both because mutual funds are the most important institutional investor, holding about 23% of all corporate equities;[130] and because they are economically closest to hedge funds. But we will also discuss, more briefly, public pension funds, the second largest category of traditional institutions, which hold 9.6% of corporate equities.[131]

A. Mutual Funds and Monitoring

1. The Plus: Size & Expertise

Compared to individual investors, mutual funds enjoy a major advantage as corporate monitors: they are large. The average size of an equity mutual fund was $218 million in 1990 and $960 million in 2004.[132] The largest mutual funds manage assets in the tens of billions of dollars.[133] In comparison, the average capitalization of stocks in the S&P 500 Index is $22 billion and of stocks in the S&P MidCap Index is $2.7 billion.

Due to their size, mutual funds enjoy significant economies of scale. These economies of scale arise in two ways. For one, they will tend to own a greater number of shares of an individual company than individual investors do. To the extent that governance activities entail company-specific costs, these costs can be spread over a larger investment. Moreover, mutual funds will tend to own shares in a larger number of companies than individual investors do. To the extent that governance activities entail

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[128] According to the Federal Reserve Board, the percentage ownership of corporate equities by households declined from 88% in 195 to 59% in 1980, while ownership by pension funds and mutual funds increased from 4% to 21%. This trend has continued, with the ownership by households declining to 33% and one ownership by pension and mutual funds increasing to 42%. Bd. of Governors of the Fed. Reserve Sys., Flow of Funds Accounts of the U.S**.,** table L.213, various years [hereinafter Flow of Funds Accounts].

[129] See generally Black, supra note 25; Rock, supra note 25.

[130] According to the Flow of Funds accounts, supra note 128, mutual funds in 2005 held $4174 of $18199 billion (23%) of corporate equities.

[131] Flow of Funds Accounts, supra note 128. Private pension funds held another 9.4% of corporate equities. Id. We do not further discuss corporate pension funds both they hold fewer assets than mutual fund, because the literature on institutional investors has expressed skepticism about whether corporate funds will be activist, and because corporate funds, unlike public funds, have not been activist.

[132] Investment Company Institute, 2005 Investment Company Fact Book (2005), tables 3 and 5.

[133] For example, Vanguard's S&P 500 Index funds has assets of $107 billion. See http://flagship2.vanguard.com/VGApp/hnw/FundsHoldings?FundId=0040&FundIntExt=INT (last visited on July 19, 2006).

costs that are common for several companies, these costs can be spread over a larger number of investments.

2. The Minuses: Regulation, Incentive Problems and Conflicts

But mutual funds also suffer from a number of disadvantages that impede their ability to act as effective monitors. These disadvantages fall into three categories: regulatory constraints, inadequate incentives, and conflicts of interests.[134]

a. Regulatory Constraints

Mutual funds are subject to a number of regulatory constraints that can affect their ability and incentives to monitor portfolio companies. For one, mutual funds are subject to special disclosure requirements not applicable to other types of investors. Specifically, mutual funds must file a semi-annual list showing the amounts and values of the securities they own.[135] This makes it harder for mutual funds to accumulate positions in portfolio companies without such companies, and the market at large, becoming aware of their activities.

In addition, in order to qualify for significant tax benefits, mutual funds must comply with the diversification requirements in subchapter M of the Internal Revenue Code. Accordingly, 50% of the assets of a mutual are subject to the limitation that the fund may own no more than 10% of the outstanding securities of a portfolio company and that the stock of any portfolio company may not constitute more than 5% of the value of the assets of the fund. Moreover, in order to advertise themselves as "diversified," – the preferred mode for most funds[136] -- funds must satisfy as well the diversification requirements of the Investment Company Act. Under the Act, 75% of the assets of a mutual fund are subject to the above limitation that the fund may own no more than 10% of the outstanding securities of a portfolio company and that the stock of any portfolio company may not constitute more than 5% of the value of the assets of the fund. These diversification requirements, in principle, limit the ability of funds to take large positions in a single company, though the constraints they pose may not be binding for larger mutual funds.

Open end mutual funds, by definition and by statute, must also stand ready to redeem their shares at the request of any shareholder at short notice.[137] The redemption

[134] See generally Black, supra note 25; Rock, supra note 25.

[135] Investment Company Act, Section 30(e)(2). In addition, under recently passed legislation, mutual funds must disclose how they voted any shares of their portfolio companies. Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564 (Feb. 7, 2003).

[136] Roe, supra note 25, at 1474.

[137] 15 U.S.C. §80a-5(2005).

price of these shares is based on the fund's net asset value. There requirements make it difficult for mutual funds to have illiquid investments: illiquid investments cannot be readily transformed into cash when fund shareholders want to redeem their shares and cannot be easily valued. The staff of the SEC therefore issued a guideline limiting the aggregate holdings of a mutual fund in illiquid investments to no more than 15% of the fund's net assets.[138]

Last not least, regulations make it difficult for mutual funds to base the fee paid to the fund management company on the performance of the fund. Performance fees must be symmetrical, such that if fees are higher than normal after a good year, they must be lower than normal after a bad year.[139] But even symmetrical pay-for-performance fees are rendered impracticable by the requirement that performance fees be based on a period of at least one year. Thus, if a fund has a stellar performance in one month, fund managers will earn an increased performance fee for the following 11 months. This, of course, creates incentives for investors to sell their shares at the end of the first month, when they have fully benefited from the stellar performance in that month but only paid 1/12 of the associated performance fee, and discourages investors from buying shares in a fund, when they have to pay 11/12 of the performance fee without getting the benefits of the stellar performance.

b. Incentives to Monitor

Activism of the variety described in Part I is not cheap. Fund managers first have to identify a company that would benefit from activism and develop a strategy for the company that would raise its share price. Then fund mangers have to pressure the company's management to adopt that strategy. All of this consumes a lot of time for the fund manager and entails significant costs for performing in-house analysis and hiring outside advisors.

For mutual funds, the incentives to expend resources on such activism are limited.[140] The lack of incentives is most pronounced for managers of indexed funds. The job of index fund managers is to replicate the performance of the index. An index fund thus competes with other funds replicating the same index principally on the basis of fund expenses. As activism is costly and thus raises the funds' expenses (or lowers the managing company's profits), index fund managers will be reluctant to engage in activism.

A similar shortage of incentives is often present for diversified mutual funds. As discussed before, regulatory barriers make it difficult for mutual funds to charge

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[138] Tamar Frankel, The Regulation of Money Managers, vol. 3 at 236 (Little Brown, 1980) (recommending 10% limit); Supplement at 83 (noting increase to 15%).

[139] Investment Advisers Act, Section 205. Hedge fund advisors are exempt by subsection (c)(7).

[140] Rock, supra note 25, at 472.

performance-based fees. As a result, 97% of all funds, accounting for 92% of all mutual fund assets, charge fees based on a flat percentage of the fund's assets under management.[141] Asset-based fees, however, provide only small direct incentives to engage in costly activism. The median stock fund in 2004 charged investors total expenses of 1.45% of assets, of which about half were management fees.[142] Thus, for example, when a manager of a $1 billion mutual fund earns additional profits of $100 million (a 10% return), total annual fees increase by $1.45 million and management fee increase by $750,000. Of course, a portion of these increased fees cover increased expenses associated with running a larger fund and fees do not increase at all to the extent that investors withdraw some of the profits. To get a sense of how much a fund management company benefits from the increased profits, assume that $1 million of the $1.45 million in total increased fees constitute profits for the fund managers and that investors keep any profits in the fund for three years before they withdraw them. Applying a 5% discount rate, the $100 million in fund profits would then generate $2.85 million in additional profits for the fund management company – equivalent to very modest implicit performance fee of 2.85%. Even this rough estimate probably overstates the implicit performance fees as most larger funds utilize "breakpoints," where the marginal percentage fee declines as fund assets increase.[143]

Even for the few funds that charge explicit performance fees, incentives are not much stronger. The reason is that, in order to avoid the problem of strategic timing of withdrawals and contributions described above, performance-fees in mutual funds are relatively flat even when they exist. Fidelity's Magellan fund for example, charges a performance adjustment of 0.02% of assets for each percentage point of outperformance or underperformance relative to the S&P 500 Index, up to a maximum of plus or minus .2%. This is the equivalent of an annual performance fee of 2% of the fund's profits (as long as the profits are within the range where the performance adjustment is made).[144]

Mutual funds, of course, can also benefit from good performance indirectly. Studies have shown that funds that outperform their peers generally attract inflows of new assets.[145] A recent study by Stephen Choi and one of us, for example, finds that a 1% abnormal positive performance by a fund (relative to other funds with the same investment objective) is associated with increased inflows of roughly 1% over the following year, while a 1% abnormal negative performance is associated with outflows of

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[141] Jesse Eisinger, Long & Short: Pay-for-Performance Bedevils Mutual Funds, Wall St. J., Apr. 13, 2005, at C 1.

[142] See More Funds Lower Fees after Scandal in 2003, USA Today, Dec. 12, 2005. Testimony of Jeffrey C. Keil, Lipper Inc., Jan. 27, 2004 [hereinafter Lipper testimony].

[143] Lipper testimony, supra note 142, at 15.

[144] Prospectus, Fidelity Magellan Fund, May 30, 2006.

[145] See, e.g., Stephen Choi & Marcel Kahan**,** The Market Penalty for Mutual Fund Scandals, Working Paper (2006); Richard A. Ippolito, Consumer Reaction to Measures of Poor Quality: Evidence from the Mutual Fund Industry, 35 Journal of Law and Economics 45 (1992).

about .6% over a year. Increased inflows, of course, generate management and other asset-based fees. The implicit performance fee generated indirectly by the effect of positive performance on inflows is thus roughly of the same magnitude as the implicit performance fee generated directly by asset-based fees.

In one important respect, however, the incentive effect of performance on net assets via inflows differs from the incentive effect of performance on net assets via profits. While the latter is a function of the funds absolute performance, the former turns on a fund's performance *relative to other funds with similar investment objectives*.[146] Activism, however, will increase a fund's relative returns only to the extent that the fund has a higher stake in the portfolio company (relative to the fund size) than competing funds do *and* the costs of activism to the fund is less than that differential. For any given portfolio company, this means that funds with a below average stake in the company (relative to fund size) have no incentives – or indeed negative incentives – to take action to increase that company's value, and funds with an above average stake have only attenuated incentives to expend resources on activism.[147]

For example, Table 1 below lists the 10 largest stock holdings as of March 31, 2005 of the Fidelity Magellan Fund and the comparable holdings in these companies (as of 12/31/04) of the Vanguard 500 Index Fund.

Table 1: Top 10 Magellan Holdings Relative to S&P 500 Index

Company	Magellan Investment (in %)	Vanguard 500 Index (in %)	Difference	Dilution of Magellan's Incentives
GE	4.1	3.4	.7	83%
Microsoft	3.0	2.6	.4	87%
Exxon Mobil	3.0	2.9	.1	97%
Citigroup	2.7	2.2	.5	81%
AIG	2.7	1.5	1.2	56%
Home Depot	2.2	0.8	1.4	36%
Bank of America	2.2	1.7	.5	77%
Viacom	2.1	0.5	1.6	24%
Pfizer	2.0	1.8	.2	90%
Tyco Int'l	1.9	0.6	1.3	32%
All 10 stocks	25.9%	18%	7.9	69% (weighted)

The last column of the table indicates the degree to which the Magellan Fund's incentives to monitor are diluted by the fact that any increase in the value of these shares would not improve the fund's performance relative to the S&P 500 index. As the table shows, the

[146] Fisch, supra note 121, at 1020.

[147] See Rock, supra note 25, at 473. And even funds with an above average stake relative to fund size have incentives to expend material resources only if the stake is significant in absolute terms.

degree of dilution is significant even for the largest holdings of the fund. For smaller holdings, the degree of dilution is likely to be even higher.[148]

c. Conflicts of Interest

Mutual funds also suffer from conflicts of interests between fund managers and fund beneficiaries which inhibit their activities as monitors of portfolio companies.[149] Many mutual fund management companies are affiliated with – in effect subsidiaries of and controlled by – another financial institution, such as an investment bank or an insurance company. For example, of the 20 largest mutual fund complexes in 2003, nine had such affiliations.[150] Managers in such funds may be reluctant to antagonize present or future clients of their parent company with their governance activities. Indeed, the effect of such affiliations on governance activism may be both more subtle and more pervasive. Consider, for example a mutual fund affiliated with an investment bank. The mutual fund managers will, ex ante, often not know which portfolio companies have hired, or are about to hire, the investment bank as underwriter or financial advisor. And, ex post, the investment banker would, for PR and legal reasons,[151] not want to interfere directly with the governance activism of the mutual fund when an investment banking client becomes the target of such activism. Thus, the easiest and safest way to avoid any problems is for affiliated mutual funds not to engage in governance activism at all. This way, mutual fund managers do not have to distinguish between portfolio companies that are investment banking clients and those that are not, and investment bankers do not have to

[148] For example, for the 10 companies in the Magellan Fund's "Consumer Staples" industry group, which account for 7.9% of the fund assets, the weighted average dilution is 78%. As further discussed below, the degree of dilution in incentives is endogenous as it is a function of a fund's investment portfolio which itself will be a function of the fund's desire to engage in activism. See infra Section II.C.5. For purposes of this section, however, we took a fund's portfolio as given to determine the incentive to engage in activism given the portfolio choice.

[149] See Rock, supra note 25, at 469; Black, supra note 25, at 601. John C. Bogle, Individual Stockholder, R.I.P., Wall St. J., Oct. 3, 2005, at A16 (noting conflicts by mutual fund managers when a proxy proposal is opposed by management and conspicuous absence of corporate governance activism). Conflicts are regarded as particularly pronounced in defined benefit plans, where fund assets are usually managed by designated corporate pension fund managers. The managers of a corporate pension fund are appointed by the executives of the corporation that sponsors the pension plan. These executives are believed to pressure pension fund managers to cast pro-management votes. Accordingly, corporate pension funds have not been regarded as likely to become active, and have not become active, in corporate governance. Black, supra note 25, at 596.

[150] The list of funds was derived from Geoffrey H. Bobroff & Thomas H. Mack, Assessing the Significance of Mutual Fund Board Independent Chairs, Mar. 10, 2004, available at http://www.sec.gov/rules/proposed/s70304/fidelity031004.httr.

[151] The potential pitfalls facing a mutual fund are illustrated by the publicity caused when Deutsche Asset management Inc., an affiliate of Deutsche Bank, switched its votes from against to for the merger of Hewlett-Packard and Compaq after it learned that Deutsche Bank provided investment banking advice to HP. See SEC, SEC Brings Settled Enforcement Action Against Deutsche Bank Investment Advisory Unit in Connection with Its Voting of Client Proxies for Merger Transaction; Imposes $750,000 Penalty (Aug. 19, 2003), at http://www.sec.gov/news/press/2003-100.htm.

worry about mutual fund managers who are spoiling their business and need to be stopped.[152]

Of course, many mutual funds companies, including the two largest -- Fidelity and Vanguard -- are not affiliated with other financial institutions. But even unaffiliated mutual fund managers, especially the larger ones, face potential conflicts. For many mutual fund complexes, the management of corporate pension plans is an important source of revenues.[153] Governance activism could lead to a loss of such business, not just with respect to the activist fund but for the complex as a whole.[154] John Bogle, the founder and former head of the Vanguard, even suggested that merely voting against management could "jeopardize the retention of clients of 401(k) and pension accounts."[155] And Don Phillips, a managing director of Morningstar, attributes the reluctance of funds to support shareholder proposals to rein in executive pay to their "desire to solicit business from corporations."[156] As in the case of affiliated funds, the effect of such conflicts on governance activism may be to deter strong activism on a broader scale. It is certainly easy to imagine that a mutual fund complex could conclude that having the reputation as a governance trouble-maker in management circles is not conducive to being picked as manager for corporate pension plans, and that the profits to be made from managing these pension plans exceed those from governance activism.

To assess the significance of these conflicts of interest, they have to be compared to the affirmative incentive a fund would have, absent any conflicts, to engage in activism. As discussed in the previous section, activism is costly and fund management companies only profit modestly from any fund profits generated by activism. Thus, in our view, even modest conflicts of interest could easily dissuade a fund management company from pursuing an activist strategy and induce it to rely instead on less conflict prone strategies – such as quantitative research or fundamental value analysis – to generate excess returns.

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[152] Cf. Gerald F. Davis and E. Han Kim, Business Ties and Proxy Voting by Mutual Funds, __ J. Fin. Econ. __ (2006) (finding that, given policies, voting by mutual funds appears to be independent of whether fund has client ties with portfolio company, but noting that funds with multiple client have are generally more likley to vote in favor of management).

[153] Gretchen Morgenson, Investors Vs. Pfizer: Guess Who Has the Guns?, Wall St. J., Apr. 23, 2006, at. Sec. 3, p. 1 (noting several mutual funds who own shares of Pfizer and manage one of its retirement plan and substantial fees paid by company to these funds).

[154] See Black, supra note 25, at 602.

[155] Letter to SEC cited in William Baue, Biting the Hand That Feeds: Mutual Fund Ties to Corporate Clients Can Affect Proxy Voting, SocialFunds.com Mar. 10, 2005 available at http://www.socialfunds.com/news/article.cgi/article1659.html. (citing to Bogle but also to a Fidelity spokesman who disclaims link).

[156] Do Mutual Funds Back CEO Pay, Wall St. J., Mar. 28, 2006, at C1.

d. Concluding Remarks

The actual activities of mutual funds are consistent with our analysis. Mutual funds have shied away from the more costly and more confrontational modes of activism: they have not instigated proxy context, they have not lead the charge in pushing for changes in business strategy or management, most mutual funds have not even made shareholder proposals, and until recently mutual funds have rarely been active in opposing or triggering corporate control transactions. If they engage in "behind the scenes" communications – and we doubt that they do so extensively – it is largely just that: efforts to coax management to change its ways, without much follow-up if management is not amenable. Capitalizing on their economies of scale, however, mutual funds have developed general policies that have lead them to support shareholder governance proposals brought by others, withhold votes from board nominees, and oppose some governance proposals made by the board.

B. Public Pension Funds and Monitoring

Like mutual funds, public pension funds enjoy significant economies of scale. The average member of the Council of Institutional Investors, an organization of large public pension funds as well as union and corporate pension funds, has assets of $22 billion. On the minus side, however, the reasons that raise concerns about the ability of public pension funds to act as effective corporate monitors differ from those related to mutual funds. Public pension funds must make quarterly disclosures of their holdings of public equity securities.[157] But, unlike mutual funds, public pension funds are not subject to specific diversification requirements,[158] face predictable liquidity requirements, and are not subject to regulatory constraints on performance fees, and have no business ties with portfolio companies that would be jeopardized by activism.

The problem of public pension funds, rather, is that they are political entities and subject to political constraints and political conflicts of interest. The make-up of the trustees of public pension funds is established by state law and differs from fund to fund. Generally, trustees consist of gubernatorial appointees, elected politicians who serve ex officio, officials elected by fund beneficiaries, or some combination of these groups.[159] For example, the trustees of CalPERS, the largest public fund, include 6 members elected by beneficiaries and 3 political appointees and 4 members who serve ex officio.[160] The New York State Common Retirement Fund, the second largest public fund, has the State

[157] See infra Section II.C.2.

[158] Public pension funds are subject to a prudent investor standard for diversification, see Romano, supra note 116. But given their size, this should not be an effective constraint on their ability to take large positions in portfolio companies.

[159] Romano, supra note 116, at 823 – 825.

[160] See www.calpers.ca.gov/index.jsp?bc=/about/organization/board/structure-responsibilities.xml.

Comptroller, a state-wide elected official, as the sole trustee. As should be evident, public pension fund trustees lack significant financial incentives to maximize fund performance.

To be sure, public pension funds can hire professional managers compensated by performance-based fees.[161] Public pension funds, however, are subject to political constraints in setting the size of these fees. As officials who are, as some commentators have noted, "accountable for their decisions to politicians or to the press",[162] they avoid calling negative publicity to their activities. The adverse publicity generated by the pay packages of the managers of Harvard University's endowment provides some indication of these constraints. Though Jack Meyer, Harvard's top investment manager, produced "stellar investment results,"[163] alumni complained that the pay of Meyer and of some of his top managers was inappropriately high. Meyer and some of his employees ended up leaving Harvard to start a hedge fund.[164] By private sector standards, however -- and certainly by hedge fund standards[165] -- Meyer's pay package ($7 million in 2004) and the one of his top two managers ($35 million in 2003 and $25 million in 2004) was laughably small considering the fact that Harvard's endowment of $22 billion would have been $12 billion smaller had Meyer earned median returns.[166] Indeed, the compensation of administrators of public pension funds is less frequently based on performance – and if it is, is less performance sensitive – than the compensation of administrators of private plans.[167]

Given the potential pitfalls from high pay packages, a politically safer course for pension fund boards that are willing to pay steep performance fees would be to entrust funds to an outside entity rather than to pay such fees to in-house managers. This, of course, is exactly what public pension funds do when they manage the indexed portion of

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[161] CalPERS pays performance fees to some of its external managers. See CalPers Annual investment Report 2005, External Manager Fees Report, available at http://www.calpers.ca.gov/invest/investmentreport-2005/investment_operations/external-manager-fees.asp and http://www.benefitnews.com/retire/detail.cfm?id=8871.

[162] Kevin Murphy & Karen Van Nuys, Governance, Behavior, and Performance of State and Corporate Pension Funds, Harvard University Working Paper, 1994, at 14.

[163] Harvard's High-Paid Star Investor Is Leaving, Boston Globe Jan. 12, 2005.

[164] Peter Grant & Rebecca Buckman, Fatter Pay Lures University Endowment Chiefs, Wall St. J., June 27, 2006, at C1.

[165] See infra Section II.C.2.

[166] At Harvard, A Question Of Compensation, Boston Globe, Nov. 29, 2004; see generally Fatter Pay Lures University Endowment Chiefs, supra note 164.

[167] See Tracie Woidtke, Agents Watching Agents? Evidence from Pension Fund Ownership and Firm Value, 63 J. Fin. Econ. 99, 104 (2002).

their portfolio in-house and invest some of their other assets in private equity funds, venture capital funds -- and hedge funds.[168]

Political constraints also inhibit public pension funds from pursuing some of the more aggressive activist strategies employed by hedge funds. It is one thing for public pension funds to sponsor shareholder resolutions demanding greater board accountability, to act as lead plaintiffs in securities lawsuits, or even to demand governance changes in underperforming companies. It is quite another for them to tell a CEO how to run her business – by opposing major strategic acquisitions, by demanding asset spin-offs, or by recommending a different business strategy – and threatening a proxy contest if management fails to be responsive. Public pension funds just lack the legitimacy to push beyond relatively uncontroversial "motherhood and apple pie" issues. Unlike CEOs or hedge fund managers, they do not have to go out to the market to compete for investment capital; their managers have little financial stake in their success; they are not subject to market penalties for failure; they are run by politicians, bureaucrats, and union representatives; and as political entities, they are subject to political pressure for overstepping their bounds.

Compounding these political constraints are political conflicts of interests. Pension fund trustees who are gubernatorial appointees or elected politicians may be tempted to pursue political ends, rather than the maximization of investment returns. In her 1993 article on pension fund activism, Roberta Romano details several instances of pension funds pursuing political goals rather than profits. In 1992, for example, the Illinois state treasurer and trustee of the pension fund threatened not to make future investments into KKR's leveraged buyout fund unless KKR preserved jobs in an Illinois plant it was selling to its employees.[169] The same year, Elizabeth Holzman, the New York City's comptroller and the trustee of the city's pension fund, publicized her active approach to corporate governance in her campaign for the Democratic nomination for New York's senate seat.[170] As related by Romano, both the New York and the California state pension funds have become subject to political pressure to tone down, and indeed did tone down, their governance activities.[171] More recently, Alan Hevesi, the very active New York State Comptroller[172] who is the sole trustee of the $115 billion New York

[168] See, e.g., News Release, CalPERS Taps Blackstone Alternative Asset Management as Advisor to $1 Billion Hedge Fund Program, May 15, 2001 (noting that CalPERS board agreed to establish a $1 billion hedge fund program in October 2000).

[169] Romano, supra note 116, at fn. 6 and 807.

[170] Id. at 822.

[171] Id. at 815-819. See also Jayne W. Barnard, Institutional Investors and the New Corporate Governance, 69 N.C. L. Rev. 1135, 1141, n. 39 (1991) (discussing political fall-out when Wisconsin pension fund submitted management-critical proposal to GM when company considered expansion in Wisconsin).

[172] Arden Dale, New York Fund Sues Merck, Citing Vioxx, Stock Drop, Wall St. J., Dec. 1, 2004 (noting that Hevesi is considered an activist comptroller and detailing suits he has filed).

State Common Retirement Fund,[173] has been criticized both for pursuing political goals[174] and for having the fund hire law firms who made large contributions to his campaign.[175]

Trustees elected by fund beneficiaries are usually union representatives, who also have objectives that may conflict with the maximization of investment returns.[176] For example, CalPERS, the largest and traditionally most active public pension fund, has come under increased criticism for the presence of union representatives on its board and the pro-union stance it has taken in various labor disputes.[177] Even to the extent that public pension funds do not pursue political or labor goals, the relatively low pay and incentives of public pension fund executives raises the specter that their governance activities are designed more for self-promotion than to enhance returns.[178]

The political constraints and conflicts of public pension funds not only make them less likely to engage in certain kinds of activism, they can also make them less effective when they become active. To the extent that public pension fund activism is perceived to be motivated politically or to serve the promotional interests of fund executives, other groups are less likely to support public funds when they become active. Without such support, however, activism is less likely to affect changes in the portfolio companies. This, again, suggest that public funds will be most effective when their activism is perceived to be least affected by political or personal motives – such as with respect to uncontroversial "apple pie" issues – and thus be inclined to limit their activism to those issues.

The actual activities of public pension funds correspond to these incentives and constraints. Consistent with their lack of business relations with target companies and the

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[173] http://www.osc.state.ny.us/pension/index.htm. (As of December 31, 2003).

[174] Editorial, Pension Fund Blackmail, Wall St. J., Mar. 3, 2005, at A10 (arguing that Hevesi was using his clout as pension fund trustee to aid John Kerry).

[175] Karen Donovan, Legal Reform Turns a Steward Into an Activist, N.Y. Times, Apr. 16, 2005, at C1; Editorial, Comptrolling Legal Authority, Wall St. J., Apr. 1, 2005, at p. A10; Editorial, Hevesi by the Letter, New York Sun, Apr. 12, 2005, online: http://www.nysun.com/article/12070. See also Woidtke, supra note 167, at 128 (concluding that public pension fund activism is motivated more by political and social goals than by firm performance).

[176] See generally Editorial, Pension Fund Blackmail, Wall St. J., Mar. 3, 2005, at A10 (arguing that the "AFL-CIO and its friends are now using pension funds to advance their political goals).; Michael Schroeder, Council of Institutional Investors is Set to Focus on Morgan Stanley, Wall St. J., Apr. 13, 2005.

[177] See Jonathan Weil, Gadfly Activism at CalPERS leads to Possible Ouster of President, Wall St. J., Dec. 1, 2004, at A1 (noting controversial CalPERS actions in interceding on behalf of striking employees of a portfolio company); Editorial, CalPERS and Cronyism, Wall St. J., Oct. 18, 2004, at A18 (noting political and union ties of CalPERS board members and accusing board of basing investment decision on political goals of labor and the Democratic party)., Jim Carlton & Jonathan Weil, Ouster Isn't Expected To Alter Calpers Policy, Wall St. J., Dec. 2, 2004, at C3. (noting that CalPERS has been criticized for "meddling in political and labor-union issues with little connection to improving shareholder returns.")

[178] Romano, supra note 116, at 822, fn. 822 (suggesting that veteran activist Dale Hanson, the former head of CalPERS, may have been so motivated); Black, supra note 25, at 598.

political interests of some trustees, public pension fund activism is somewhat more open and confrontational than activism by mutual fund: public funds make more shareholder proposals, publish lists of target companies, and apply to become lead plaintiffs in securities class actions. But the choice of targets – companies that have been underperforming or have been accused of major fraud – and the substance of activism – calling for greater board accountability, opposing excessive CEO compensation, and the like – insulate the fund from political backlash. And – as they lack the incentives and the credibility to do so -- public funds have steered clear of demanding specific changes in strategy or management, have not engaged in proxy contests, and have so far not even joined forces with hedge funds in opposing or triggering corporate control transactions.

C. Hedge Funds and Monitoring

1. Size

Since hedge funds are largely unregulated, substantially less data is available about hedge funds than about other institutional investors. However, the available evidence suggests that hedge funds enjoy significant economies of scale. According to estimates, there are approximately 8,000 hedge funds with aggregate assets under management of over $1 trillion.[179] These figures indicate suggest that the average hedge fund had assets of about $100 million. The largest hedge funds have assets of about $10 billion.[180] While smaller than the comparable figures for mutual funds and pension funds, these figures probably understate the effective assets of hedge funds. Unlike mutual funds and pension funds, hedge funds regularly use leverage and invest in derivatives which enable them to take positions that are much larger than those of mutual funds with similar net assets. Thus, according to industry sources, 30% of hedge funds use a leverage ratio in excess of 2 – meaning that the total dollars invested are more than twice the total equity – and another 40% use leverage at a lower ratio.[181]

2. Regulatory Constraints

Hedge funds are not subject to any specific regulatory constraints. They must, however, comply with rules applicable to investors generally. These constraints include the disclosure requirements under section 13(d) of the Securities Exchange Act requiring disclosures by persons who own more than 5% of the equity securities of a public company and the short-swing profit rules under Section 16(b) applicable to 10% shareholders and directors of a company.

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[179] The Economist, Hedge Funds and the SEC: Still Free, July 1, 2006, at 68.

[180] Institutional Investor Magazine's Alpha Names Farralon Capital Mgmt the World's Largest Hedge Fund Firm in their Annual Hedge Fund 100, PRNewswire, May 27, 2005.

[181] See www.hedgefund.com/abouthhfs/attributes/Leverage/leverage.htm.

In addition, all institutional investment managers – including hedge fund managers – are subject to the disclosure requirement of section 13(f) of the Securities Exchange Act. Under that provision, certain investment managers (including mutual fund as well as pension fund and hedge fund managers) must make disclosures about their holdings on a quarterly basis. The disclosure requirements under Section 13(f) differ, however, from those applicable to mutual funds in two important respects. First, and most significantly, only holdings of registered equity securities – so-called "13(f) securities" need to be disclosed. 13(f) securities include traded shares and options listed on an exchange. Importantly, however, holdings of other options and derivatives need not be disclosed in one's 13(f) filings. As a result, hedge funds can use derivatives to accumulate large economic positions in portfolio companies without disclosure unless they become subject to the disclosure requirements under section 13(d). Secondly, no disclosures at all must be made if one's holdings of 13(f) securities are less than $100 million. Thus, small and even medium size hedge funds can avoid making any disclosures as long as a sufficiently large percentage of their holdings are in debt securities or in non-listed equity derivatives.

Hedge funds also have a greater ability to invest in illiquid assets than do mutual funds. While mutual funds are required to redeem shares on short notice and SEC guidelines limit the percentage of assets that mutual funds can hold in illiquid investments, hedge funds are not subject to any similar regulatory requirements. Contractually, hedge fund investors have more limited withdrawal rights than mutual fund investor. Traditionally, hedge fund investors could make withdrawals only after an initial lock-up period of six months. More recently, some hedge funds have extended the initial lock-up period to two years or longer.[182] Once the initial lock-up has expired, further restrictions apply. In particular, hedge funds usually require advance notice for withdrawals and sometimes permit withdrawals only at specific points in time and impose limit on the amounts an investor can withdraw at any point.[183] In addition, hedge funds may refuse a withdrawal request if the withdrawal would be harmful to other investor in the fund or "pay" a requested withdrawal "in-kind" rather than in cash.[184] In conjunction, these provisions make hedge funds much less sensitive to sudden liquidity shocks than mutual funds are.[185]

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[182] See, e.g., Ex-Chairman of S.E.C. Set to Start Hedge Fund, N.Y. Times, Sep. 13, 2005 at C1 (reporting that investors in new hedge fund can only redeem initial funds after 2 years, and thereafter only annually); Hedge Funds Avoid SEC Registration Rule, Wall St. J., Nov. 10, 2005, at C1 (noting that several hedge funds have adopted a 2-year lockup period, in part to avoid SEC registration rules). The increased lock-up may contribute to hedge fund activism. See Two-Year Lock-Up for hedge Funds Seen as Promoting Activist Strategies, BNA Sec. Reg. & L. Rep., Apr. 3, 2006 at 569.

[183] Henny Sender, Citadel Pulls Up its Withdrawal Bridge, As Hedge Funds Aim to Block the Exits, Wall St. J., Jan. 13, 2006, at C1 (noting that Citadel charged penalty on investor who wanted to withdraw more than 3% of its money).

[184] Interview with Nathan Fischel, Jan. 2, 2006.

[185] Hedge funds also have a greater ability to take on debt than mutual funds. Under the Investment Company Act, mutual funds are required to have a three to one asset to debt ratio. Investment Company Act, §18(f), 15 USC 80a-18(f). (As most mutual funds have no debt to speak of, this regulatory constraint

3. Incentives to Monitor

As we discussed above, traditional institutional investors suffer from impaired incentives to monitor portfolio companies. The incentives to monitor by hedge funds differ in several important respects from those of traditional institutions. First, hedge fund managers are highly incentivized to maximize the returns to fund investors. The standard hedge fund charges a base fee equal to 1-2% of the assets under management and a significant incentive fee, typically 20% of the profits earned.[186] This fee structure gives hedge fund managers very significant stakes in the financial success of the fund's investments. These stakes are even higher when, as is frequently the case, a hedge fund manager has invested a significant portion of her personal wealth in the hedge fund.[187]

Secondly, many hedge funds strive to achieve high absolute returns, rather than returns relative to a benchmark.[188] In particular, the industry-standard 20% incentive fee is usually based on a fund's absolute performance. And while a few funds use a hurdle rate before the incentive fee is payable, this hurdle rate is generally a rate based on the yield of debt securities, not a rate based on the performance of a market index or an index of hedge funds with similar investment objectives.

Thus, unlike mutual funds, hedge funds benefit directly and substantially from achieving high absolute returns. For successful managers, the resulting profits can be extraordinary high. Thus, the average take home pay for the top 25 hedge fund managers in 2003 was $207 million; and the lowest paid manager in that group still earned a respectable $65 million.[189] For 2004, the average was $251 million and the lowest paid received $100 million.[190]

Of course, hedge fund managers, like mutual fund managers, care also about retaining existing and attracting new investors through their performance. But even to the extent that hedge fund performance is, for this purpose, assessed relative to a benchmark or to other hedge funds with comparable strategies, their incentives are diluted to a lesser

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in unlikely to be binding.) Hedge funds are not similarly limited and, by all accounts, often are far more leveraged.

[186] See www.hedgefund.com/abouthhfs/what/what.htm. This fee is usually structured to incorporate a high-water mark, but not a claw back. I.e., if a fund makes losses, these losses have to be made up before any incentive fee is payable (high water mark); but if a fund makes profits and earns an incentive fee, the fee does not have to be returned if the fund suffers subsequent losses (no claw back).

[187] E-Mail from David Haarmeyer to Marcel Kahan, Apr. 4, 2006.

[188] Financial Services Authority, Hedge Funds: A Discussion of Risk and Regulatory Engagement (June 2005) at 10.

[189] Stephen Taub, The Buck Stops Here, Institutional Investor, Aug. 2004, at 47.

[190] Stephen Taub, Alpha's Top 25, Institutional Investor's Alpha, May/June 2005, at 15.

extent than those of mutual funds. The reason is that hedge fund portfolios resemble the relevant index much less than those of mutual funds. Reliable data on hedge fund holdings are not available since hedge funds must only disclose their holding in equity securities and listed options, and not any other derivatives. We are thus not able to calculate the percentage dilution in hedge fund incentives similarly to the way we calculated Magellan's dilution in incentives. But hedge fund managers we talked to confirmed that hedge fund investments were definitely much more eclectic and less correlated with a market index or with investments of another hedge fund with a similar investment style than those of mutual funds.[191] As one of them put it: Eclecticism "is what we are selling."[192] As a result, hedge funds need not worry much that competitor funds will free-ride on their governance activism and get higher returns with lower costs.

And even if the activism by one hedge fund boosts the returns of activist hedge funds more generally, the result may not be all that bad. Investors use returns of funds with a certain investment style to determine the amount of money they invest in this sector of funds. If activism by one activist hedge fund boosts the returns of activist hedge funds more generally, more money will flow into this sector benefiting all activist funds.[193]

4. Conflicts of Interest

Hedge funds suffer from fewer conflicts of interests between fund managers and fund investors than traditional institutional investors. First, most hedge funds are independent investment vehicles and are not affiliated with any other institution. Of the 20 largest hedge funds in 2004, only one was affiliated with another financial institution such as a bank or insurance company. By contrast, as reported above, of the 20 largest mutual fund complexes in 2003, nine were so affiliated. Furthermore, anecdotal evidence suggests that even hedge funds that are affiliated with other financial institutions do not shy away from taking actions that are antagonistic to investment banking clients of their affiliates. Recently, for example, the Highbridge Fund, majority owned by J.P. Morgan, accumulated a 25+ percent stake in convertible bonds of Saks Inc. and then sent a "notice of default" when Saks breached a covenant by failing to file financial statements with the SEC – even though Saks has an investment banking relationship with J.P. Morgan.[194]

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[191] Interview of Hedge Fund Manager (anonymous), Jan 30, 2006.

[192] Id. Hedge funds specializing in merger arbitrage may be an exception in this regard in that their investments are highly correlated with those of other hedge funds specializing in merger arbitrage.

[193] Moreover, investors in hedge funds tend to be highly sophisticated. As a result, they may tend to use more complex evaluation criteria and channel their investment to the funds that took the lead in activism, and not those that free-rode.

[194] Highbridge Fund Sent Default Note to Retailer Saks, Wall St. J., June 20, 2005 at C5 (the article further suggests that Highbridge bets on Saks stock declining and aims to make money from a short position in Saks).

Indeed, recently concern has been expressed that investment banks sacrifice the interests of other clients in order to cultivate and retain lucrative hedge fund business.[195]

Second, unlike mutual funds, hedge funds do not manage companies' defined contribution plans. They accordingly do not have to be concerned that activism will result in a loss of fund management business. In sum, hedge funds are, to a much greater extent than mutual funds, free from the most significant potential sources of conflicts of interest.[196]

To be sure, hedge funds may still face some conflicts to the extent they want to attract contributions by defined benefit corporate pension funds that are run by management-appointed trustees. (Mutual funds, of course, would also face similar conflicts.) But we believe that, at least for hedge funds, these conflicts tend to be minor. For one, hedge funds may not be that interested in capital from private pension funds. If private pension funds, together with public pension funds, account for more than 25% of the capital of a hedge fund, the hedge fund becomes subject to regulations under ERISA[197] – a fate unattractive to a sector that is otherwise largely unregulated. More importantly, however, we do not think that corporate pension funds have been or will become a substantial source of direct funds for hedge funds. Historically, corporate pension funds have not been significant contributors to hedge funds. Rather, hedge funds have obtained most of their capital from wealthy individuals and institutions such as foundations or university endowments.[198] More recently, corporate (as well as public)[199] pension funds have started to make investments in hedge funds. While we lack precise data, we do not believe that, at this point, corporate pension funds are a major source of

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[195] Testimony Concerning Hedge Funds by Susan Ferris Wyderko, Director, Office of Investor Education and AssistanceU.S. Securities & Exchange Commission, Before the Subcommittee on Securities and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs (May 16, 2006) (available at the SEC website , http://www.sec.gov/news/testimony/ts051606sfw.htm); FSA Bloodhounds Pursue Hedge Funds; Financial Services Authority, Securities Industry News (May 16, 2005).

[196] Cf. Attacks of the Hungry Hedge Funds, BusinessWeek online, Feb. 20, 2006 (noting that hedge funds, unlike mutual funds, are not trying to sell money management services to companies).

[197] Department of Labor, Definition of ``plan assets''-- plan investments ("Plan Asset Regulations"), 29 C.F.R. Sec.2510.3-101(f). (cf. http://www.dol.gov/dol/allcfr/Title_29/Part_2510/29CFR2510.3-101.htm and http://www.shearman.com/files/Publication/0527637a-386d-4edd-b83b-b4babc648872/Presentation/PublicationAttachment/a8795ffd-7839-4515-8787-d058684f9ae2/eceb_092004.pdf).

[198] Jason Singer, Ivy Leave: Yale Parts Ways with Hedge Funds, Wall St. J., Mar. 29, 2006, at C1 (chart noting that 25.7% of Yale's endowment is invested in hedge funds).

[199] News Release, CalPERS Taps Blackstone Alternative Asset Management as Advisor to $1 Billion Hedge Fund Program, May 15, 2001 (noting that CalPERS board agreed to establish a $1 billion hedge fund program in October 2000).

capital for hedge funds.[200] And given the declining importance of corporate defined benefit plans,[201] we are skeptical that they ever will become one. Finally, even to the extent that corporate pension funds invest in hedge funds, they tend to do so through funds-of-funds, rather than directly.[202] But hedge fund managers do not know the identity of the investor in the fund-of-funds, and investors in the fund-of-funds do not always know what hedge funds their money flows to. The presence of fund-of-funds thus serves to further insulate hedge funds from pressure by corporate pension funds.

Whatever residual conflicts of interest may remain, they have to be compared to the affirmative incentives to enhance investor returns. As explained, hedge fund management firms and managers derive substantially greater benefits from increased fund returns than do mutual fund management firms and managers. As a result, any conflict of interest is more likely to be resolved in favor of hedge fund investors. On the whole, therefore, we do not believe that conflicts of interests are likely to interfere with activism by hedge funds, or at the very least that they do so much less than in the case of public pension funds and mutual funds.

5. Activism and Stakes

In the end, the incentives for a fund to engage in activism depend on its stake in a portfolio company.[203] In this regard, it is noteworthy that activist hedge funds usually accumulate stakes in portfolio companies *in order to engage in activism*. There are numerous examples of hedge funds taking stakes whose value depends on firm actions, and then taking action – everything from trying to influence strategy, running proxy contests, instigating litigation, and threatened to vote against mergers – to determine the outcome.

Hedge funds in this regard differ markedly from mutual funds and public pension funds. Mutual fund and public pension fund activism, if it occurs, tends to be intermittent and ex post: when fund management notes that portfolio companies are underperforming,

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[200] The Hennessee Group recently estimated that public and private pension funds combined account for 9% of the sources of capital to hedge funds. See Hennessee Group LLC Hedge Fund Industry Growth, January 2005.

[201] In 1995, private pension funds held corporate equities of $1.3 trillion, amounting to 15% of the total market value of corporate equities. By 2005, private pension funds held corporate equities of $1.7 trillion, amounting to 9% of the total market value of corporate equities. Flow of Funds Accounts, supra note 128, tables L213 and L118.

[202] Jane B. Kenney et al., The Hedge Fund, Institutional Investor, June 1, 2003 ("Much of the new pension money enters the market through funds of hedge funds.")

[203] In addition, hedge funds may structure their portfolios so that they profit from activism in various ways. As discussed below, for example, it is likely that Highfields stood to profit from a defeat of the MONY – AXA merger both through its holdings on MONY shares and through its holdings of ORANs. On the plus side, this can allow hedge funds to increase their returns from successful activism thereby overcoming rational apathy or free riding. See infra Section III.A.2.

or that their governance regime is deficient, they will sometimes become active.[204] In contrast, hedge fund activism is strategic and ex ante: hedge fund managers first determine whether a company would benefit from activism, then take a position, and then become active**.** It represents a blurring of the line between risk arbitrage and battles over corporate strategy and control.

This suggests that the differences in activism between hedge funds and other institutions may be, at least in part, endogenous. Because (activist) hedge funds pursue activism as a profit-making strategy, they take economic positions in portfolio companies that enable them to make profits from activism and engage in activism. Because traditional institutions do not pursue activism as a profit making strategy, they do not take positions for the purpose of becoming active and accordingly engage in less activism. Put differently, the difference in activism is, in part, due to the fact that hedge funds and traditional institutions pursue different profit strategies.

Viewed from this perspective, the relevant question becomes why (some) hedge funds pursue activism as a strategy and why (most) traditional institutions do not. In part, the answer to this question may lie in the fact that traditional institutions face regulatory barriers, political constraints, or conflicts of interest that make activism less profitable than it is for hedge funds.

But in part, the difference in strategies may be due to the fact that mutual fund view and market themselves as vehicles for diversification which enable their investor to gain broad exposure to markets at low costs. To be a successful activist, it is probably helpful for a fund to engage in activism as a principal strategy: activism presumably entails learning, with funds that have done more of it becoming better at it, and funds with an activist reputation can more easily attract support from other investors and induce management changes. But an activist strategy does not mesh well with a diversification objective because strategic activism is relatively expensive and requires a fund to take relatively large positions in relatively few companies. Hedge funds, by contrast, do not see themselves as vehicles for diversification and engage in targeted hedges, rather than diversification, to eliminate unwanted risk.[205] More narrowly tailored strategies -- such as activism – are thus more appropriate for hedge funds than for mutual funds.[206]

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[204] See, e.g., Smith, supra note 112, at 231 (describing target selection process used by CalPERS).

[205] Perhaps more importantly, hedge funds have less of a need to diversify because investors in hedge funds, unlike many investors in mutual fund, are already substantially diversified through their other holdings. Put differently, hedge fund investors have a greater tolerance for risk generated by their hedge fund investment than mutual fund investors have with respect to their mutual fund investment.

[206] Even non-activist hedge funds tend to pursue more narrow tailored investment strategies such as merger arbitrage and convertible bond arbitrage. Of course, some "multi-strategy" hedge funds pursue broader (or a combination of narrower) strategies and some mutual funds, such as sector funds, offer lesser diversification benefits. (By the same token, of course, some mutual funds, such as Mutual Beacon**,** are relatively activist.) On the whole, however, the mutual fund sector is dominated by funds with broadly diversified portfolios while the hedge fund sector is characterized by funds with narrowly tailored strategies.

III. Problems Generated by Hedge Fund Activism: Conflicts and Stress Fractures

Although hedge funds hold great promise as active shareholders, their intense involvement in corporate governance and control also raises some concerns. Hedge funds are set up to make money for their investors without regard to whether the strategies they follow benefit shareholders generally. A hedge fund who owns shares in, say, company A, may try to use that position to increase the value of another position, say in company B, rather than to maximize the share price of company A. Indeed, because hedge funds frequently engage in hedges and other sophisticated trading and arbitrage strategies, such conflicts of interest are likely to arise more frequently for hedge funds than for other institutional investors. We examine these "hedging related conflicts" in Section A.

In addition to these direct conflicts, we also address a secondary problem related to hedge fund activism. Hedge funds combine high powered incentives with great sophistication and access to vast pools of capital. Together, this can put great stress on the existing governance system. We examine some of these potential "stress fractures" in Section B.[207]

We conclude this Part by commenting in Section C on the absence, so far, of a third set of problems: managers buying off activist hedge funds through the payment of greenmail or similar devices. We leave the most common, and potentially most serious, criticism leveled against hedge funds -- that hedge funds, due to their short-term trading horizons, aggravate an already serious problem of "short termism" in the executive suite – to be analyzed in Part IV.

In assessing the need for a regulatory response to these problems, there are several considerations. First, to what extent does the existing regulatory structure adequately address the concerns? Here, we consider whether the problems are of a familiar type, and then whether the increased pressure on the system imposed by hedge funds overwhelms the existing tools. When a problem is a standard corporate law problem, we presume that the existing regulatory structure is adequate unless some specific aspect of hedge fund involvement changes the analysis. If, on the other hand, problems are of a new type, they may require new tools.

If one concludes that the current structure is inadequate, one then needs to consider which of the various tools available is most appropriate. In this regard, there are three general categories of potential responses. One can rely on market forces (e.g.

[207] We do not concern ourselves with the extent to which the interests of hedge fund managers may diverge from the interest of hedge fund investors, or what to do about any such divergence. Although an important question, it is beyond the scope of this Article.

competition among hedge funds, reputation), employ self-help (charter amendments, contracts), or resort to regulation.

While the specific response obviously depends on the specific nature of the problem, it is critical to bear in mind that hedge fund activism is not static. Hedge funds are among the most nimble market actors, with a track record of coming up with new strategies, some of which are designed to exploit imperfections in the very responses developed to the old strategies. Moreover, hedge funds are not only clever, but quick. So in choosing a mode of response, speed and flexibility are very important. This suggests that the market forces and self-help are better designed to deal with these problems than regulation is. The reason is two-fold. For one, private actors can generally react more quickly than regulators. Second, private actors have a greater ability to learn from each other in devising a proper response.

As we will see, many of the problems discussed in this Part are familiar and classic corporate law problems. Despite the increased pressure applied by hedge funds, our general view is that the traditional solutions, perhaps with increased enforcement, and supplemented by market responses and possibly some additional disclosure requirements, should suffice. We are not indifferent to the possibility of illegal or improper behavior; rather our view is that the current regulatory structure can handle it, with minor exceptions.

A. The Dark Side: Hedging-Related Conflicts

1. Buying (Control) v. Selling (Shares)

As the earlier anecdotes show, hedge funds are sometimes potential buyers, not sellers. When a hedge fund is a potential buyer of a company in which it has a stake, its interests clearly and obviously diverge from those of its fellow shareholders: the hedge fund wants to buy at the lowest possible price while the other shareholders want to sell at the highest possible price. A hedge fund's activities may not be so much directed at making sure that the target is sold at the highest price, but rather at increasing the likelihood that the hedge fund succeeds in its acquisition attempt.

This is a very old problem in corporate law that is analyzed under the rubric of the duty of loyalty. While hedge funds' interests clearly diverge from general shareholder interests when they are seeking to buy control, this conflict is obvious, with management and other shareholders being aware of it and on guard against it. Moreover, hedge funds will generally have no control over the target company they are trying to buy. We therefore believe that no special response is necessary.

2. Conflicts in Merger Votes

A more subtle conflict can arise in control transactions when a hedge fund owns other securities the value of which depends on whether the transaction is consummated. Such conflicts featured prominently in the proposed acquisition of MONY, a publicly traded life insurance company, by AXA, the large French financial conglomerate, where hedge funds both favoring and opposing the deal had conflicts of interest.[208] Highfields -- a hedge fund with nearly 5% of MONY -- led the opposition by MONY shareholders, running full page ads in the Wall Street Journal urging MONY shareholders to reject the merger,[209] convincing Institutional Shareholder Services, a proxy advisory firm, to recommend a "no" vote on the deal,[210] and establishing a website (www.demandfairvalue.com) to aid MONY shareholders in exercising their appraisal rights.[211]

But Highfields' interests were not pure. In order to finance its cash acquisition of MONY, AXA had issued a convertible debt security, known as "ORANs", to its shareholders which would convert into AXA shares on completion of the acquisition but be redeemed at face value plus interest if the acquisition was not completed by December 21, 2004. Given the relative values involved, the ORANs would be significantly more valuable if the AXA-MONY deal went through. Highfields held a large short position in ORANs, a position that would become more valuable if the merger did not close. [212] Other hedge funds favoring the merger, in turn, were long on ORANs and apparently purchased MONY stock at a premium in order to vote for the merger.[213] Eventually, after a postponement in the meeting (which allowed shareholders who had bought stock

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[208] In re MONY Group Inc. S'holder Litig., 853 A.2d 661, 668 (Del. Ch. April 9 2004, revised Apr. 14, 2004).

[209] Sara Hansard, MONY Delays Vote as Dissidents' Effort Gains Steam; CRAIN COMM., Feb. 23, 2004, at 25. Highfields even mailed a letter to shareholders urging them to vote "no" on the merger and enclosed a duplicate of the corporate proxy card so that shareholders, should they choose, could easily cast a no vote. This was the subject of federal court litigation with the issue being whether this constituted an exempt solicitation under Rule 14a-2(b)(1). MONY Group, Inc. v. Highfields Capital Mgmt., L.P., 368 F.3d 138, 141 (2nd Cir. 2004). Highfields won in the District Court, but the decision was reversed by the Second Circuit which held that, under the circumstances, the duplicate management proxy card was a "form of revocation" and thus rendered the solicitation non-exempt. Id. at 145 ; see also In re MONY Group Inc. S'holder Litig., 853 A.2d at 669; .Southeastern Asset Management Demands That AXA/MONY Disclose Information Regarding Arbitrage of AXA Bonds [hereinafter Southeastern Asset Management Demands]; BUS. WIRE, Apr. 30, 2004, http://www.businesswire.com.

[210] Hansard, *supra* note 209, at 43. "ISS said the sale price 'is outside the boundary of reasonableness when compared to precedent transactions coupled with open-market opportunities to sell above the offer price.'" *Id.*

[211] Highfields Capital Establishes Web Site for MONY Shareholders Exercising Appraisal Rights, PR NEWSWIRE, Mar. 31, 2004, http://www.prnewswire.com.

[212] In re MONY Group Inc. S'holder Litig., 853 A.2d at 668.

[213] Innisfree Presentation, supra note 27. In a presentation to the MONY board, CSFB, the Board's independent financial advisor, "noted that as of the Board meeting, anyone long ORANs would receive an approximate 46% profit if the merger was consummated, compared to a 2.4% profit if it was not." 853 A.2d at 671 n.29.

after the previous record date to vote) and much litigation, the MONY merger squeaked through, with 53.8% of the outstanding shares voting in favor.[214]

In a world in which more than fifty percent of all equities are held by institutional shareholders, such conflicts are pervasive. But, while pervasive, they are not necessarily bad. Index funds, for example, will own shares on both sides of many mergers between public companies. In such cases, their financial interest will be to maximize the value of their portfolios and should approve a merger if it is value enhancing, without regard to the magnitude of the premia paid to shareholders, even if shareholders of individual firms, qua shareholders, might prefer higher premia. Where hedge funds differ, and potentially exacerbate the pervasive conflicts, is that they choose to invest in both sides of a deal and acquire stakes *in order to* influence the outcome, in contrast to index funds which simply find themselves on both sides.

Corporate law has long lived with, and tolerated, conflicts of interest in voting by shareholders. Hedge funds may be more likely to have such conflicts than traditional institutional investors and may choose to create such conflicts, but the conflicts of hedge funds pale compared to the conflicts of controlling shareholders in freeze-outs, whose votes will usually be outcome-determinative. And controlling shareholders are entitled to vote their shares in their (conflicted) self-interest, unencumbered by any fiduciary duties to minority shareholders.[215]

As such, we see little need to impose stricter duties on hedge funds or on voting conflicts more generally.[216] Absent empty voting, the effect of conflicted votes is self-limiting;[217] conflicted funds are often on both sides of the contested issue and their votes thus cancel each other out;[218] the market is often aware of, and can respond to, these conflicts; all diversified shareholders, including all institutional investors, will often find themselves with similar conflicts; and the board of directors, which does have fiduciary duties, can take measures to counteract any dangers.[219]

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[214] Floyd Norris, Holders of MONY Approve $1.5 Billion Sale to AXA, N.Y. TIMES, May 19, 2005, at C4 (noting that "[e]ssential to approval may have been a block of 8.7 percent of the shares owned by Deutsche Bank").

[215] Bershad v. Curtiss-Wright Corp, 535 A.2d 840 (Del. 1987).

[216] We suspect that a more common occurrence is that hedge funds have economic interests that are disproportionate to their voting interest as a result of options of other derivatives which have a value that correlates with the stock price but no voting rights.

[217] As long as the economic interest of a hedge fund corresponds at least to the voting rights, the hedge fund will suffer proportionally with other shareholders from any value decline.

[218] See also Section III.A.3 (discussion of conflicts in King-Mylan merger vote).

[219] In our working paper, "The Hanging Chads of Corporate Voting," we address potential responses to empty voting and other conflicted voting in greater detail.

3. Empty Voting

A particularly extreme form of a hedging-related conflict arose in the proposed Mylan/King merger. In July 2004, Mylan Laboratories entered into a merger agreement with King Pharmaceutical, according to which, subject to shareholder approval, Mylan would acquire King for Mylan shares. Perry, a hedge fund, was a large shareholder in King (approximately 7 million shares) and supported the merger. While the deal was seen as favorable to King, the market reaction to the merger for Mylan was negative and some large shareholders of Mylan, including Carl Icahn, threatened to vote against it. As a result, approval of the merger by Mylan shareholders was in doubt.[220]

Perry then acquired 9.9% of Mylan's shares. At the same time, Perry apparently entered into "equity swaps" with Bear Stearns and Goldman Sachs which fully hedged its economic exposure to Mylan's share price. As a result, Perry acquired shares -- and votes -- in Mylan, which, because it had no economic stake in Mylan, it could vote purely on the basis of his interest as a King shareholder – and thus in favor of the merger.[221] Indeed, this was presumably Perry's purpose.

The divergence between the interests of Perry and those of other Mylan shareholders is evident. If the merger is good for King but bad for Mylan, as many Mylan shareholders apparently felt, Perry would still vote its sizeable position in Mylan in favor of the merger and could help push it through. As it happened, King had to restate its earnings, which caused Mylan management to terminate the merger agreement. The success, and legal validity, of Perry's strategy thus was not tested.[222]

"Empty voting" is an example of an old problem – conflicts of interests created by exploiting the separation of legal and beneficial ownership – aggravated by modern financial innovation. Perry took advantage of modern financial instruments to acquire votes. While, functionally, Perry's actions appear to be a form of "vote buying," legally they do not seem to fall with the existing jurisprudential framework. Indeed, as we argue

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[220] Robert Steyer, New Player Joins Mylan-King Fray, The Street.com, Nov. 29, 2004.

[221] The issues relating to empty voting are extensively discussed in Shaun Martin & Frank Partnoy, Encumbered Shares, 2005 U. Ill. L. Rev. 775, and Henry T.C. Hu & Bernard Black, Empty Voting and Hidden Ownership: Taxonomy, Implications, and Reforms, (April 2006), U. of Texas Law, Law and Econ Research Paper No. 70, available at SSRN: http://ssrn.com/abstract=887183.

[222] Other, more traditional conflicts of interest in voting were also present. Icahn had a stake of about 10% in Mylan, both in terms of economic exposure and in terms of voting rights. But Icahn also had a shorted 5.3 million shares of King stock. Icahn Wins as Mylan-King deal Dies, Forbes.com Newsletter, Mar. 4, 2005. Icahn could thus have an economic interest to oppose the merger, even if the merger were in the interest of Mylan, as long as the market thought that the merger would be significantly more beneficial to King. In that event, Icahn would gain more from a defeat of the merger through his short position in King than he lost on account of his long position in Mylan. Suppose Icahn shorted the King shares at $30 per share, that the shares would go up to $40 per share if the merger is completed but down to $20 per share if the merger fails. Icahn would then profit from defeating the merger if his profits from shorting are greater than the increase in the value of his Mylan stake from approving the merger.

at greater length elsewhere, the existing regulatory structure does not prohibit it. If empty voting turns out to be a significant problem – and it is not clear that it is – new measures will be required, either through regulation or by common law decision making.

That said, how exactly the law should be changed, if it should be, is a highly complex question. This complexity arises from several directions: multiple mechanisms can generate empty votes; current legal rules do not treat these mechanisms equivalently; other problems related to compilation of broker votes interact with the concerns raised by empty voting; and, at present, neither the market, nor companies, nor regulators have the information necessary to determine the presence and extent of empty voting schemes.

The development of a proper response is made even more complicated by the fact that companies and investors have an interest in determining the outcome of a vote speedily. Thus, any more intrusive legal regime that involves protracted litigation generates special problems in the context of voting rules. Moreover, it is unclear to what extent market responses (such as the increasing costliness of hedging strategies around critical votes) temper empty voting. We address these issues in a companion paper in which we examine the extent to which the existing technology and regulation of voting is sufficient given the pressures imposed by current activity. For the purposes of this Article, we agree with Henry Hu and Bernie Black that not enough is known about the extent of empty voting to prescribe anything more than possibly an increase in disclosure of schemes generating empty votes.[223]

B. Stress Fractures

With billions of dollars available, and super high powered incentive compensation structures, hedge funds put stress on the existing governance structures. In doing so, they highlight and exacerbate existing structural weaknesses, albeit not necessarily in a manner that generates a conflict of interest with other shareholders. In this Section, we address two such potential weaknesses: undisclosed concerted action and overvoting.

1. Undisclosed Concerted Action

In many of the battles between managers and hedge funds described earlier, the shareholder base of companies can change almost overnight with hedge funds collectively sometimes ending up with more than 50% of the shares. Managers and their counsel have speculated that hedge funds act in concert, both in the acquisition of their shares and in the subsequent pressuring of management, without filing the required disclosure statements under Section 13(d) of the Securities Exchange Act. Indeed, say some, there is a pervasive problem of section 13(d) underenforcement by the SEC.

We do not know whether this is true or not. If there is, in fact, a problem of underreporting, it presents an interesting parallel with the 1980s. During that period in which hostile tender offers assumed prominence, management complained that hostile

[223] Hu & Black, supra note 221.

bidders and their allies operated behind the scenes to the disadvantage of shareholders and companies. Now, again, one hears complaints that it is hedge funds (some run by the same raiders who managers complained about in the 1980s) that are operating behind the scenes.

But there is an important difference between non-disclosure by raiders in the 1980s and any non-disclosure by activist hedge funds today. The acquisition of a 5% stake by a raider was highly material, market-moving information. By delaying a 13(d) filing, raiders and their allies would be able to acquire additional shares at a substantially lower price. By contrast, hedge fund activism has much less of an immediate market impact. Moreover, hedge fund corporate governance activities, in any event, are usually conducted publicly , with hedge funds issuing press releases long before they reach the five percent filing threshold under Section 13(d). Finally, hedge funds (unlike most raiders) must disclose their equity holdings quarterly under Section 13(f). Thus, while hedge funds, like all other investors, ought to comply with 13(d), one wonders what all the fuss about a failure to disclose is about.

To be sure, a 13(d) filing can yield information that would otherwise not become public. Specifically, a 13(d) filing could reveal the presence of a conflict of interest, such as an empty voting scheme.[224] Indeed, it was this 13(d) requirement that forced Perry to reveal its hedging positions in the Mylan King battle. Where such conflicts exist, and would have to be disclosed in a 13(d) filing, a failure to make the filing constitutes a serious problem. But it does not appear that such conflicts are common.

In addition, most poison pills incorporate the 13(d) concept of a group into the pill trigger. Thus, it may sometimes be the case that an undisclosed formation of a "group" would trigger the pill – to the serious harm of the participating hedge funds and, one assumes, to the delight of management and their lawyers.[225] In that case, however, management is in a good position to respond: it can argue that the hedge funds have formed a group, declare the pill triggered, dilute down the members of the alleged group, and wait to be sued. Given the incentives for management to pursue such cases, this does not seem to be area to which the SEC need devote its limited enforcement resources.

The key issue here thus seems to us not a failure of the SEC to bring enforcement actions but the vagueness of the concept of "group" underlying section 13(d) and the poison pill. Rule 13d-5 provides that "when two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer, the group formed thereby shall be deemed to have acquired beneficial ownership."[226]

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[224] Section 13(d) requires the disclosure of any contracts and other arrangements in which hedge fund dispose of their economic interests. Securities Exchange Act, Section 13(d)(1)(E). But section 13(d) does not have a per se requirement to disclose conflicts of interest.

[225] Phyllis Plitch, Lawyers See No Poison Pill to Feed Hedge Fund 'Wolf Packs', Corporate Governance, Dec. 21, 2005, at 4.

[226] Rule 13d-5(b)(1).

Section 13(d)'s reporting obligations are thus triggered by concerted conduct, but not by parallel action. The fact that a variety of hedge funds crowd into the shares of a company at the same time does not per se establish the formation of a group any more than the mere fact that competing manufacturers raise their prices at the same time can establish a price fixing agreement in violation of the Sherman Act. Proving that parallel conduct is concerted action is difficult, both in the antitrust and in the 13(d) context.

To that extent, hedge fund activism may raise a somewhat novel problem. Up to recently, the issue of unaffiliated parties acting in parallel to influence a public company – and the accompanying evidentiary ambiguity as to whether a group has been formed -- has not arisen that often. Rather than bring more enforcement actions, the SEC may want to provide regulatory clarification of when a group is formed.

2. Overvoting

The current voting technology is seriously flawed. Some argue that it is so flawed that, in any reasonably close corporate vote – the number of which are increasing with increasing hedge fund involvement – it would be impossible to prove which side has prevailed.

Since 1973, to avoid the overwhelming record keeping problems of paper shares, companies use a book entry system, with share certificates held by the Depositary Trust and Clearing Corporation (DTCC). Individual brokerage houses each have accounts with DTCC in which, under the standard arrangements between customers and their brokerage firms, holdings of customers are commingled in a single, fungible mass. DTCC's records simply indicate that Merrill Lynch, for example, has 20,000 shares of Firm X, without indicating how many shares specific customers of Merrill hold. As Merrill Lynch's customers buy and sell, Merrill's net holdings will change, but it is Merrill's responsibility to keep track of its customers' holdings.

When it comes time for the shareholders of X Corp. to vote, the company will typically retain a firm, usually ADP, to handle the distribution of proxy materials, the solicitation of proxies, and the tabulation of the votes.[227] ADP receives a listing of holdings by brokerage house from DTCC and a list of customers' accounts from the participant firms. It will then send out proxy materials, including proxy cards indicating the number of shares in a customers account, to all those who appear on brokers' lists. Customers will fill out their cards, return them to ADP, with the results then passed on to the firm.

This system breaks down when there is significant short selling, as is often the case when hedge funds are involved. Consider what happens when someone "shorts" a

[227] Typically, firms will retain ADP Investor Communications Services which claims a 95% market share. http://ics.adp.com/release11/public_site/about/ics_story.html.

stock.[228] In a short sale, a brokerage house typically arranges for a short seller to acquire shares from a custodian bank which holds shares (in a fungible mass) for its custodial clients (such as mutual funds, pension funds and insurance companies), subject to an obligation to return a share at some later date.[229] The short seller will then sell the shares to some third party, who will take full title and be entirely oblivious to the source of the shares.

Because a short sale involves an actual transfer of shares, it creates substantial difficulties in determining who has a right to vote shares, principally because tracing is not possible, and record keeping and communication is incomplete.[230] Suppose that Merrill has 20,000 shares of X in its DTCC account, while Goldman has 30,000 shares in its account. A hedge fund HF "borrows" 5,000 shares from Merrill and, to go short, sells them to a customer of Goldman. Once that sale is completed, DTCC records will show that Merrill has 15,000 shares of X while Goldman has 35,000 shares.

The problem is now clear: DTCC's omnibus proxy will transfer the right to vote 15,000 shares to Merrill, and inform ADP of this. But Merrill will give ADP a list of all its customers' holdings in Firm X for a total of 20,000 shares. ADP will then send out proxy materials according to the brokers' customer lists, with the result that it will send out proxy cards for more shares than are in fact entitled to vote. In this example, although Merrill and Goldman collectively only hold 50,000 shares, their customers will receive proxy cards representing 55,000 shares. Because the shorted shares are often not attributed to specific customer accounts, it is unclear which customers are entitled to vote. If fewer than 15,000 Merrill shares are voted, this problem is shoved under the table by pretending that the Merrill customers who returned proxies were all entitled to vote and some of those who did not return proxies anyhow were not entitled to vote. But if more proxies for more shares are returned than are entitled to vote – because the level of short-selling was high and the abstention rate was low – it is unclear what should be done.

There are several possible effects of this system for collecting votes. First, it may mean that some people who are shareholders are unable to vote their shares. Second, it may mean that others who may not in fact own any shares (because they lend them out) will nonetheless be able to vote. Finally, it may result in a situation in which there is no answer to the question of who is entitled to vote.

The MONY/AXA deal, discussed above, is an example of a contested transaction that illustrates these problems. The controversial buyout was approved by a margin of

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[228] For an excellent account, see Robert C. Apfel, John E. Parsons, G. William Schwert & Geoffrey S. Stewart, Short Sales, Damages and Class Certification in 10b-5 Actions, Working Paper July 2001, available from SSRN.

[229] Christopher C. Geczy, David K. Musto & Adam Reed, Stocks are Special Too: An analysis of the equity lending market, 66 J. Fin. Econ. 241 (2002).

[230] Here we follow the excellent discussion in Apfel et al., supra note 228.

1.7 million votes out of a total of 50.1 million shares at a time when somewhere around 6.2 million shares had been shorted.[231]

Though the overvoting problem has been noted for a long time,[232] it is becoming more acute now because hedge funds activism makes close votes more likely and hedge funds engage in short selling at the time of votes. We discuss the problem in greater detail, and examine possible solutions, in a separate paper.

C. The Absence (So Far) Of a Third Conflict: Paying Hedge Funds Off

It is worth noting that we have not found any evidence for the existence of a third potential conflict between hedge funds and other investors: hedge funds and managers making a side deal in which the firm pays the hedge fund to go away, such as greenmail. We are not aware of a single instance of hedge funds receiving greenmail, one of the 1980's classic instances of "dark side" behavior. The absence of greenmail is interesting in its own right. One possible explanation is that greenmail got such a bad name during the 1980s that hedge funds are too embarrassed to touch it, or perhaps more plausibly that boards are too embarrassed to offer it. Alternatively, the absence of greenmail or similar devices may reflect the fact that there are so many hedge funds around that greenmail or similar devices will not provide firms with any protection and may well elicit even greater interest. Or finally, accepting greenmail may not be in the long-term interest of activist hedge funds because it would undermine their credibility and their ability to obtain the support of other investors (which they may need to succeed in their activism) the next time around.

IV. Pervasive Short Termism?

Although many of the "dark side" problems identified in Part III have generated comment and controversy, the sharpest and most comprehensive criticism of hedge fund activism is that they exacerbate an already serious problem of "short termism" in the executive suite. In this Part, we take that criticism seriously.

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[231] Bob Drummond, Corporate Voting Charade, Bloomberg Markets, April 2006, at 96.

[232] A 1991 House report recommended that the SEC promulgate a rule to handle this situation, and, specifically, a rule that prohibits brokers and dealers "from soliciting proxy voting instructions from or giving proxies at the direction of beneficial owners for more shares than the net amount owned beneficially by each beneficial owner, as shown on the books and records of the broker or dealer, after subtracting the short security positions of each beneficial owner." "Short-Selling Activity in the Stock Market: Market Effects and the Need for Regulation," Part I, Report of the Committee on Government Operations, U.S. House of Representatives, Dec. 6, 1991, at 33. More recently, the New York Stock Exchange has also identified this as a problem and is working on a solution. See NYSE Information Memo No. 04-58 (Nov. 5, 2004) ("Several recent special examinations of member organizations' proxy departments have discovered significant areas of concern involving an apparent systemic over-voting of proxies and a general lack of effective supervision.")

A. A Real Problem?

Hedge funds come close to being the archetypical short-term investor.[233] For some funds, holding shares for a full day represents a "long term" investment. Short-termism may thus pervade much that hedge funds do, including their corporate governance and control activism. Leading opponents of hedge fund activism, such a Martin Lipton, argue that hedge fund short-termism could cause managers not to make crucial long-term investments.[234] And the German finance ministry set up a panel to assess the impact and consider regulations of "short-term profit oriented foreign investors."[235] One's views about whether hedge fund activism, on the whole, is desirable or undesirable are likely to turn on one's stand on the short-termism problem.[236]

Looking at the specific activities of hedge funds, there is often an inherent ambiguity as to whether they sacrifice valuable long-term projects in favor of short term gains. Consider Deutsche Boerse's (DB) failed attempt to acquire the London Stock Exchange, discussed earlier. DB's CEO wanted to acquire the LSE and convinced the board that doing so was a good idea. Hedge funds who had acquired large stakes in DB disagreed. They maintained that the plan to acquire the LSE represented wasteful managerial empire building and that DB's cash hoard should instead be distributed to shareholders. Now, if the investment in acquiring the LSE was a valuable long-term project, then the involvement of the hedge funds had the effect of pushing the company

[233] Rita Raagas De Ramos, Concerns Over Hedge Funds Rise as Market Volatility Rises Globally, Wall St. J., June 13, 2006, at C5 (noting that hedge funds make up 40% to 50% of average dayly trading volume in major financial markets.

[234] See Battling for Corporate America - Shareholder democracy, The Economist, March 11, 2006 (U.S. Edition), at 69; Martin Lipton, Attack By Activist Hedge Funds, March 7, 2006. Even if they are short-term oriented, hedge funds' short term strategies may perform valuable functions. For example, when hedge funds are playing their traditional role of arbitraging market inefficiencies, their pursuit of short-term profit will be one of the mechanisms that helps to bring the market price into alignment with the value of the firm. Thus, for example, when prices are too high because of excessive optimism, hedge funds can be expected to short the stock thereby putting some necessary downward pressure on the price. Moreover, even if the interests of short-term and long-term investors may occasionally conflict, their interests will often coincide. To that extent, hedge funds, by furthering their own short-term interests, will also benefit long-term shareholders.

[235] Hedge Funds Face Europe's Clippers, supra note 23, at C5.

[236] There is so far little empirical evidence on the effect of activism on company value. A recent study by Citigroup looks at the impact of hedge fund activism on the stock price of target companies adjusted for market returns. Citigroup, Hedge Funds at the Gate, Sep. 22, 2005. The study involves a small sample, no controls, and no statistical analysis. It shows that target of hedge funds activism experience above average returns after the announcement of the activism, but that these returns evaporate in the two months following the announcement when the activism is not M&A related. The study, however, also shows that stock price of activism targets outperforms the markets in the two months preceding the announcement of the hedge fund activism. To the extent that this increase is attributable to the market anticipating this announcement or to price pressure from hedge fund purchases, even non-M&A related activism is associated with above average returns during the study period. Given the design of the study, it obviously does not address the issue of whether hedge funds aggravate short-termism.

towards the lower value outcome, an outcome worse for long-term shareholders than acquiring the LSE. If the hedge funds were right that the investment was simply a bad investment driven by delusions of grandeur, their opposition benefited both short-term and long-term shareholders.[237]

For the short-term trading horizon of hedge funds to generate a short-term investment outlook for hedge fund managers, the stock market must suffer from "myopia:" that is, it must undervalue long-term investments relative to short-term investments. If the market does not itself suffer from such a bias, then the interests of investors with short-term trading horizons will not conflict with those of investors with long-term trading horizons. In the case of the DB's attempt to acquire LSE, for example, a conflict between hedge funds with short-term trading horizons and other investors with long-term horizon would exists only if the market myopically fails to incorporate the long-term benefits of acquiring LSE into the stock price of DB.

Whether and under what circumstances the market suffers from myopia has been the subject of substantial analysis and debate. Many managers, directors, private equity funds, investment bankers and others involved in the management and sale of companies are convinced that the market is myopic. Others believe that the short-term/long-term distinction is a foil for managerial failure to deliver results.[238] Academics have developed theoretical models showing that market myopia can result in a number of circumstances.[239] Much of the current research in finance starts from the assumption that

[237] This analysis nicely illustrates the different ways in which hedge fund involvement, when it crosses a critical threshold, can affect shareholders. Were hedge funds only to hold a small percentage of either DB or LSE, and the market overvalues the value of the transaction to the companies, they could bet against the DB bid for LSE by shorting DB stock. If they could be short for a long enough time, they would make money if it turned out that they were right that this was empire building; they would lose money if it turned out that this was value enhancing. While, in the DB case, the hedge funds were likely right, there are other cases in which they bet against a complex strategy and lost. The clearest case seems to be Lampert and Kmart and Sears. When Lampert acquired control of Kmart, the stock was heavily shorted. But within a year, the stock had gone from $15 per share to $108 per share. Had those with the short view held a controlling position, they may have blocked the strategy, to shareholders' detriment.

[238] See Barry Rosenstein, Activism is Good for All Shareholders, Fin. Times, Mar. 10, 2006.

[239] See, e.g. Richard Kihlstrom & Michael Wachter, "Why Defer to Managers: A Strong Form Efficiency Model," (working paper 2006); Jeremy Stein, Takeover Threats and Managerial Myopia, 96 J. Pol. Econ. 61 (1988) (presenting model of myopia under asymmetric information); Jeremy Stein, Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate behavior, 104 Quart. J. Econ. 655 (1989); Andrei Shleifer & Robert Vishny, Equilibrium Short Term Horizons of Investors and Firms, 80 Am. Econ. Rev. 148 (1990); see also Lucian Bebchuk & Lars Stole, Do Short-Term Managerial Objectives Lead to under- or over-investment in Long-Term projects?, 48 J. Fin. 719 (1993) (model where short-term focus leads to overinvestment in long-term projects).

capital markets are not perfectly efficient.[240] But the empirical evidence on the extent and magnitude of myopia is sketchy at best.[241]

Arguably, the phenomenal growth of private equity funds, whose basic business model includes taking companies private so that they can be reconfigured away from the short term pressures on public companies, indicates that there may well be a serious problem of myopia. KKR, Blackstone, Carlyle, Apollo and TPG have all raised, or are currently raising, new funds in excess of $10 billion.[242] But then again, the business model of private equity funds also includes providing high-powered incentives to managers and monitoring them closely. Whether private equity and activist hedge funds pursue complementary strategies for maximizing firm value (with both targeting managerial agency costs in a different fashion), whether they are competitors in the same markets (as private equity funds open hedge funds and hedge funds take companies

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[240] For a short survey, see Michael Wachter, Takeover Law when Financial Markets are (Only) Relatively Efficient**,** 151 U. Pa. L. Rev. 787 (2003).

[241] Some of the studies focus on the effect of institutional investors, which have been argued to have a shorter-term trading horizon that other investors, on managerial myopia. See, e.g., Brian Buschee, The Influence of Institutional Investors on Myopic R&D Investment Behavior, 73 Acct. Rev. 305 (1998) institutions generally reduce myopic pressure, but institutions with high turnover that engage in momentum trading encourage myopia); Sunil Wahal & John J. MCConnell, DO Institutional Investors Exacerbate Managerial Myopia?, 6. J. Corp. Fin. 207 (2000) (concluding that presence of institutional investors, regardless of investmern style, permits companies to invest more in long-term projects); M. Bange & W. DeBondt, R&D Budgets and Corporate Earnings targets, 4 J. Corp. Fin. 153 (1998) (less earnings management for R&D when institutions own higher stakes); Sumit K. Majumdar & Anuradha Nagarajan, The Long-Term Orientation of Institutional Investors: An Empirical Observation (finding that institutuions prefer to invest in firms with long-term orientation) (1997) [The Impact of Changing Stock Ownership Patterns in the United States: Theoretical Implications and Some Evidence, Revue D'Economie Industrielle, 82, 4, 39-54.] Other studies focus on the effect of the threat of the hostile takeovers, which Lipton and others have suggested generates undesirable short-termism, on R&D expenses and similar measures of long-term investments. While one study found that, consistent with the short-termism hypothesis, R&D expenses increase after the enactment of anti-takeover legislation, two other studies found that R&D declines after the adoption of anti-takeover provisions. See Muelbroeck et al., Shark Repellants and Managerial Myopia: An Empirical test, 98 J. Pol. Econ. 1108 (1990) (finding that R&D expenses decline after adoption of anti-takeover provision); Mark Johnson & Ramesh Pao, The Impact of Antitakeover Amendments on Corporate Financial Performance, 32 Fin. Rev. 659 (1997) (same); but see Pugh et al., State Antitakeover Legislation and Shareholder Wealth, 13 J. Fin. Res. 221 (1990) (finding that they increase). Yet others look at other aspects of myopia. See, e.g., Anup Agrawal & Jeffrey F. Jaffe, The Post-Merger Performance Puzzle (rejecting EPS myopia as explanation for negative long-run stock returns after mergers); Federico Ballardini, Do stock Markets Value Inovation? A Meta-Analysis (finding that the market values $1 invested in R&D more than $1 invested in tangible assets); Craig W. Holden & Leonard Lundstrum, Costly Trading, Managerial Myopia, and Long-Term Investment (finding that introduction of long-term options (LEAPS) is associated with increase in long-term investments) Mei Cheng et al., Earnings Guidance and Managerial Myopia (finding that firms dedicated to giving earnings guidance enage in more myopic R7d investments); Jeffrey S. Abarbanell & Victor Bernanrd, Is the US Stock Market Myopic? (concluding that stock prices do not generally exhibit myopic behavior) .

[242] Peter Smith, Texas Pacific raises record $14bn for new fund, Financial Times April 3, 2006 (TPG has raised more than $14bn for latest fund; Blackstone raised at least $13.5bn for its latest fund; Apollo Management recently raised over $10bn and KKR is doing so too. More than $250bn is estimated to have been raised by private equity funds in 2005).

private), or whether hedge funds aggravate market imperfections and thus drive firms into the arms of private equity remains unclear.

Short-termism thus presents the potentially most important, most controversial, most ambiguous, and most complex problem associated with hedge fund activism. The other dark side problems represent relatively isolated and narrow concerns that do not much relate to hedge fund activism as a whole. Short-termism, by contrast, arguably pervades hedge fund activism and the accusation that hedge funds induce managerial short-termism has become the main line of attack for hedge fund critics. At the same time, the very existence of a short-termism problem is least proven; its manifestations, if it does exist, are most manifold; and potential solutions are least evident.

B. Potential Responses?

Let us assume that hedge fund managers tend to prefer that companies engage in projects with short-term payoffs even if there are projects with longer term payoffs that are more valuable. Should the law intervene and, if so, how?

The answer to this question depends on a number of factors. First, even if hedge funds have short-term biases, to what extent is hedge funds activism *driven by* excessive short-termism? Activist hedge funds are agents of change with specific goals that depend on the particular company. When the company is diversified, hedge funds often push for divestitures. When it is underperforming, they often push for the sale of the company or a change in management. When the company has excess cash on hand, they push for stock repurchases or dividends. When the company has assets on its balance sheet that can be monetized (e.g., real estate), they push to monetize those assets. When companies are pursuing capital intensive investment plans, hedge funds sometimes oppose the plans and push for the cash to be returned to shareholders. In the control area, hedge funds sometimes make bids, sometimes oppose deals on the acquirer side (but sometimes try to push for deals), and often try to get better terms for the target. Is it always the case, when a hedge fund gets involved, that it is pushing for business strategies with a short-term pay-off over strategies with a more valuable long-term pay-off? Or is the short-term payoff preferred by hedge funds sometimes the more valuable one? And how often is hedge-fund activism motivated by altogether different concerns, such a bad management, an ill-advised strategy, or an insufficient price in an acquisition?[243] Is the controversy really about different investment horizons or does it instead reflect a substantive dispute over the appropriate course of action for the firm?

Second, how long is the horizon of managers? A plausible story can be told that it is managers, and not (just) markets, which suffer these days from myopia. Many CEOs are close to retirement age and, even among younger CEOs, turnover is high. Executive stock options continually vest and are exercised or hedged, if only to diversify their

[243] See, e.g., Janet Adamy, Investor Peltz urges Heinz to Shed More Lines, Pare Payments, Wall St. J., May 24, 2006 (hedge funds asking company, among other things, to shed line of Italian baby food and use new forms of marketing to increase ketchup consumption).

portfolio. Bonuses are often based on short-term performance goals. Is it sometimes management's failure to invest in valuable long-term projects that created the opening for hedge fund activism?

Third, when and to what extent do hedge funds succeed in affecting corporate policy? Though hedge funds have become highly active in the corporate governance area, they have generally not become powerful enough to exercise control over the targets of their activism.[244] Rather, they purchase a sizeable but far from controlling stake – rarely more than 5% to 10% -- and then seek to influence corporate strategies.[245] Even when hedge funds commence a proxy contest, they usually seek only minority representation on the board. Activist hedge funds often have a chair at the metaphorical table where corporate strategy is set: an opportunity to have their views heard and paid attention to. But in order to see their views prevail, hedge funds usually need the support of others[246] -- which cannot be taken for granted.[247] These others include, in particular, corporate management, independent directors, traditional institutional investors with large stakes, and other large shareholders. To the extent that the largest shareholders are effectively indexers, a strategy that results in a short term increase in share prices (that benefits hedge funds) but a long term loss (that hurts long term shareholders) will not be attractive. More generally, over time, the degree of support that hedge funds receive will likely depend on whether long term shareholders benefit.

Fourth, if the determination of corporate policy once hedge funds are involved depends on multiple constituents, how do these constituents interact? At present, it seems that hedge funds often act as a counterweight to the substantial power of management, with the consequence that the effective power is partly shifted to other groups, such as independent directors and traditional institutional investors. Independent directors and large shareholders, of course, may sometimes make mistakes, but management is not infallible either. We are inclined to be optimistic about the resulting interaction, which often results in a compromise rather than outright victory for hedge funds or management.[248] But another possibility – though one that we have so far not

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[244] See Shareholder Activism in the M&A Context, supra note 124 ("In larger transactions [the success of hedge funds in blocking a deal] will often require that the activists' position be supported by more traditional institutional investors and ISS.")

[245] See supra Section I.A.; see also Phyllis Plitch, Lawyers See No Poison Pill to Feed Hedge Fund 'Wolf Packs', Corporate Governance, Dec. 21, 2005, at 4 (hedge funds "typically acquire a stake of less than 10%"). Even when several hedge funds become active in a specific portfolio company, they generally do not control it. See supra Section I.A.

[246] See Rosenstein, supra note 238 (characterizing hedge fund activism as a "campaign between hedge funds and managers for the support of the Company's true owners, its shareholders")

[247] See Financial Institutions Developments, Wachtell, Lipton, Rosen & Katz, Feb. 22, 2006 at 4 (noting success by some firm in persuading large institutional shareholders to support board).

[248] Attacks of the Hungry Hedge Funds, supra note 156 (noting that "there is scope for the warring parties to find a mutually beneficial resolution.")

witnessed – is that hedge funds will enter an unholy alliance, either by being bought off by management through the payment of greenmail or its functional equivalent or by teaming up with other large shareholders to advance their respective parochial interests to the detriment of shareholders at large.

Given these questions, a sufficient case for legal intervention has not been made. Our conclusion partly results from the uncertainties, about whether short-termism is a real problem, about the nature of the problem, about how much it affects hedge fund activism, and about how hedge fund activism relates to potential managerial short-termism. It partly results from our observations that, at present, hedge funds influence but do not control corporate policy, that they depend on the support of other shareholders, and that they have shied away from extracting greenmail and other similar unsavory tactics.

But our conclusion rests to a large extent on our view, which we have developed elsewhere,[249] that companies (and the market more generally) will take what we have called "adaptive devices" to deal with the potential negative effects of hedge fund short-termism. To see the shape of some of these devices, one need look no further than the "Hedge Fund Attack Response Checklist" mailed by Martin Lipton to the clients of his firm. In this widely circulated memo, Lipton recommends that companies prepare in advance for hedge fund activism by: periodic updates of the board of directors; review of dividend policy; improved financial public relations; consistency in one's strategic message; proactively addressing reasons for any shortfall in peer company benchmarks; regular, close contact with major institutional investors; a review of basic strategy with the board; and so on.[250] These are terrific ideas, not just to deal with activist hedge funds, but in general. If companies follow Lipton's advice, hedge funds will already have made significant positive contributions to the management of U.S. companies. Moreover, if hedge funds can succeed despite companies taking these measures, we think that chances are reasonably high that they have a good point.

One adaptive device missing from Lipton's list – but one which merits particular attention – is private equity. Vast sums are now available to take companies private, sums largely provided by the same (allegedly myopic) institutional investors who hold the shares of public companies -- and invest in hedge funds. And as we have noted above, private equity can be an escape mechanism for companies that suffer from

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[249] Marcel Kahan & Edward B. Rock, How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law, 69 U. CHI. L. REV. 871 (2002).

[250] Martin Lipton, Attacks by Activist Hedge Funds, Wachtell, Lipton, Rosen & Katz, Mar. 7, 2006. See also Hedge Fund and Institutional Shareholder Activism 7, Mayer Brown Rowe & Maw, April 21, 2006 (recommending that companies review their dividend policies, proactively address reason for any shortfall in performance, and maintain close contact with major investors); Shareholder Activism in the M&A Context, supra note 124 (recommending that companies in M&A context be proactive in explaining the reasons for and the benefits of a transaction, ensure that the board's position be accurately understood, and engage and early and open communication with significant stockholders)..

excessive short-term pressures in the public market.[251] If it is indeed hedge funds that contribute substantially to such short-term pressures, it is no small irony that hedge funds and traditional private equity funds are nowadays converging. In an increasing number of high-profile deals, hedge funds have taken on the type of long-term control investing that has previously been the exclusive domain of private equity funds.[252] If hedge funds are part of the problem because their activism exacerbates short-termism, they may be also part of the solution, as they develop private equity expertise. This by itself shows how multi-faceted hedge funds are as an investment vehicle, and should caution against adopting hasty regulation.

Conclusion

We are observing an evolutionary process in real time. Hedge funds -- highly incentivized, mostly unconflicted, and largely unencumbered by regulatory constraints -- have become the prime corporate governance and control activists. They pursue activism as a profit-making strategy, make investments in order to become activist, rather than as an afterthought to a failed portfolio investment, and thus blur the line between risk arbitrage and governance and control battles. The emergence of, and the role played by, hedge funds proves that there is money to be made from being an active shareholder.

One of the most intriguing developments we are starting to observe is the division of labor between the hedge funds and the more traditional institutional investors. Because hedge funds are typically relatively undiversified, they show little interest in agitating for systemic changes such as anti-poison pill or staggered board campaigns. On the other hand, hedge funds – highly incentivized and subject to few conflicts of interests -- engage in firm specific agitation to a degree unheard of among traditional institutional investors, with traditional institutions sometimes tagging along. As one traditional institution said, in connection with the battle to stop Deutsche Boerse's attempt to acquire the London Stock Exchange, "The hedge funds have done a marvelous job. No matter how we feel about companies, traditional managers simply cannot move as fast to achieve our aims. We were right behind (the hedge funds), but we couldn't have done it without them."[253]

But there is also a potential downside to activism. The interests of hedge funds sometimes diverge from those of their fellow shareholders and activism creates stress fractures for the regulatory system. The most serious accusation leveled against activist funds, however, is that activism is designed to achieve a short-term payoff at the expense

[251] See Hedge Fund and Institutional Investor Activism (noting that private equity funds are looking to take private targets of shareholder activism).

[252] See Woodrow W. Campbell & Jennifer A. Spiegel, Hybrid Vehicles, The Deal, June 18, 2005; Innisfree Presentation, supra note 27.

[253] Louise Armitstead, Saved by the growing power of hedge funds, Sunday Times (London), March 13, 2005.

of long-term profitability. It is here where the challenge for boards, traditional institutional investors, and the market as a whole lies. If the proposals made by hedge funds are sometimes valuable and sometimes misguided, how good are we in figuring out which is which? While we do not pretend to know the answer to this question, we believe that market forces and adaptive devices taken by companies individually in response to activism are better designed to help separate good ideas from bad ones than additional regulation.

Hedge funds are here to stay. They are prominent in control transactions and elsewhere. Their influence is being felt. But the future is uncertain. As hedge funds grow, will they retain their separate identity (and get stronger) or will (some of them) morph into high-fee mutual funds? Will activist investment opportunities for hedge funds dry up as more money chases these opportunities, or will more hedge funds become activist in response to the profits to be earned? If smart hedge fund investors keep hedge fund managers honest, will expansion of investor base reduce the monitoring of hedge fund managers and make them less good agents for their investors?

Finally, one can predict a backlash, although the exact form it takes will depend on what scandal occasions the regulatory intervention. We are already beginning to see a regulatory reaction with the SEC, with a (failed) attempt to adopt rules requiring the regulation of hedge fund advisers,[254] and preparation for regulation in Europe. When there is the inevitable crisis, there will be pressure to regulate further. At this point, the most important injunction, obvious in a period of calm but less so after an explosion, is to regulate cautiously and carefully.

[254] Hedge Funds and the SEC, supra note 179.