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Activist Investors: A Corporate Social Responsibility Perspective on Hedge Fund Activism and the Need for Focus on All Stakeholders

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**ACTIVIST INVESTORS: A CORPORATE SOCIAL RESPONSIBILITY
PERSPECTIVE ON HEDGE FUND ACTIVISM AND THE NEED FOR
FOCUS ON ALL STAKEHOLDERS**

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Abstract

Corporate social responsibility (CSR) can result in distinctly different visions when instituted under the enlightened stakeholder theory or the shareholder maximization theory. The critical variation between these two theories is the principal party that businesses consider when instituting strategic decisions. Firms following the enlightened stakeholder theory will base decisions on all the various stakeholders of the company and develop policies which increase long-term firm value. Companies pursuing shareholder value maximization will consider all strategies through the eyes of the stockholders and how these individuals will be affected. Neither theory is more valid than the other, since many factors must be assessed. However, if companies are earnest about the CSR concept, they should give significant consideration to the impact that their decisions will have on employees, communities, and other stakeholders, as well as long-term value.

The extent to which business decisions affect all stakeholders should be at the forefront of company strategy. Prioritizing the desires of a select few over the needs of the majority, many of whom are significantly impacted by company policies, does not evidence the desire to improve society. Corporate social responsibility is an opportunity for firms to demonstrate their comprehensive focus on all affected groups. Corporate leadership is challenged to value the communities, culture, and all stakeholders over short-term profit, even without monetary gain from their actions. The enlightened stakeholder theory balances the needs of corporate constituencies, while pursuing long-term value creation and producing an optimal environment for sustainable CSR success.

Key Words: Corporate Social Responsibility, Stakeholder Value Maximization, Enlightened Stakeholder Theory, Corporate Governance, Hedge Fund Activism

Introduction

Corporate social responsibility (CSR) has become a topic of much discussion during the past several decades, as more companies spotlight attention on the impact that they leave on the world. Falck and Heblich, in their 2006 article “Corporate Social Responsibility: Doing Well by Doing Good,” define CSR as “voluntary corporate commitment to exceed the explicit and implicit obligations imposed on a company by society’s expectations of conventional corporate behavior” (p. 247). CSR challenges companies to consider their commitment to society in addition to their profitability, including the effects of their actions on the community, environment, and all stakeholders. Proponents of this self-regulation argue that a company can excel financially while also contributing to global well-being.

The importance of CSR can be understood when considering the lasting mark that companies have on their communities and humanity in a relatively short period, for good or ill. Without a critical awareness of the importance of their long-term approach, businesses and corporations may spend less time considering the impact of their decisions. Corporate social responsibility provides the framework for companies and individuals to reflect on their policies and acknowledge the various stakeholders whose existence will be altered by failure to enact sustainable strategies. By engaging in efforts to improve environmental, legislative, economic, political, and communal conditions, companies add value to their surroundings and create further opportunities for societal growth. Through these actions, companies fulfill their responsibility toward bettering the world, while at the same time strengthening their reputation through philanthropic measures.

The inherent merit of CSR is that both the company and other stakeholders often benefit by the deliberate actions of the corporation. Not only is the condition of society improved, but the public image of the organization is elevated. According to Harris (2016), approximately one half of a company’s reputation is based on the public’s “perceptions of the firm’s CSR.” When stakeholders witness the altruistic and humanitarian aid pledged by a company, they are more likely to “buy products, recommend the company, say something positive about the company, work for the company and invest in the company” (Harris, 2016). A company that looks beyond profit alone inspires loyalty from the surrounding community and fosters recognition of the value added to society through charitable measures.

Evidence of the success of CSR can be seen via many prominent companies, including Ben & Jerry’s, TOMS, Bosch, and Starbucks. While each corporation’s charitable works take different

forms, the legacy that it strives to leave promises a brighter future for society. For example, Vilas (2017) details that Ben & Jerry's donates 7.5% of their pre-tax earnings to charity, while TOMS provides a pair of shoes to the underprivileged for every pair purchased. Bosch, the American appliance company, allocates "50% of its R&D budget in technologies supporting conservation and environmental protection," and Starbucks has committed itself to ethically sourced coffee through the "Sustainable Coffee Challenge." The commitment of these companies to assisting and improving the lives of others is evidenced by their corporate initiatives, resulting in the appreciation of society for their efforts and the esteemed position of these organizations within the public eye.

CSR Theories

Many theories exist regarding Corporate Social Responsibility and its role in improving the lives of corporate stakeholders. Each theory has different criteria governing the effectiveness of the actions taken by the company. Written by Garriga and Melé in 2004, the article "Corporate Social Responsibility Theories: Mapping the Territory" classifies the most well-known theories into four categories: instrumental, political, integrative, and ethical. This classification encapsulates the many ideologies that shape the present-day CSR landscape and expands the rationale behind their prominence.

Instrumental theories, also commonly known as economic theories, conclude that a "corporation is an instrument for wealth creation and that this is its sole social responsibility" (Garriga & Melé, 2004, p. 52). Accordingly, if an action does not move toward this goal, it should be discontinued. Perhaps the most well-known theory under this category is shareholder value maximization, which advocates that a company should only undertake socially responsible acts if it also benefits. If an initiative results in a cost to the business, the venture should be foregone. Jensen (2002) states that the maximization of firm value acts as "the objective function that will guide managers in making the optimal tradeoffs among multiple constituencies" (p. 12), in this case focusing on stockholders.

Another economic theory revolves around the allocation of resources in an effort to meet the CSR goals set by the company and to bolster corporate reputation. Companies decide on the dispersal of charitable contributions based on how the donation assists the company strategically. This cause-related marketing theory allows a company to differentiate itself reputationally through

socially responsible measures. The methodology of companies following the marketing strategy involves the promise to contribute to or back a cause or organization “when customers engage in ... revenue-providing exchanges that satisfy organizational and individual objectives” (Garriga & Melé, 2004, p. 55). Consumers feel good about purchasing items sold by an organization if they believe that the firm acts with integrity and with the welfare of other people in mind.

Companies that implement instrumental theories can engage in charitable activities that benefit many different organizations and causes, while at the same time safeguarding the shareholders and company. A company’s profits and shareholder value are kept in the foreground and always considered when choosing philanthropic causes. Under these theories, the shareholders of the company benefit because decisions are geared toward advancing their future as well. The corporation also profits since as the shareholders are pleased by the strategies of the company, and the reputation of the firm may also increase as positive publicity arises from company philanthropy and activism. However, a company refrains from assisting society after a certain point to protect its financial and strategic well-being. Therefore, subsets of society that are not directly applicable to a company’s business may not benefit directly, because the firm must profit in the long term from the philanthropic activity.

Political, or legal, theories concentrate on “the social power of corporation ... specifically in its relationship with society and its responsibility in the political arena associated with this power” (Garriga & Melé, 2004, p. 52). Companies focus primarily on their social rights and duties regarding the well-being of society. The first major theory is corporate constitutionalism, which upholds that company leadership must use its power responsibly. Keith Davis, an early pioneer in CSR academia, formulated the two principles underlying this theory, the social power equation and the iron law of responsibility (Garriga & Melé, 2004, p. 55). The social power equation dictates that the social responsibility of business professionals originates from their degree of social power within their organization. In turn, the iron law of responsibility holds that those individuals who are irresponsible with their social power will forfeit it to other parties who act in a trustworthy manner (Garriga & Melé, 2004, p. 56).

The second political theory is corporate citizenship, which views the business as a citizen and therefore holds it to the same civic duties as an individual. Firms must consider the community that is affected by their decisions and appropriately adjust their actions to incorporate local, national, and global needs. Political theories tend to empower companies to recognize the value of their authority and to wield it appropriately. Executives in leadership positions are held to high

standards and viewed as role models. Both corporate citizenship and corporate constitutionalism result in numerous positive philanthropic initiatives and greater appreciation for the efficacious impact of businesses on their surroundings. However, firms must be wary of drawing too heavily on their perceived influence and appearing self-congratulatory to the public. In a similar vein, companies must regard their charitable work as an opportunity to improve society, instead of a box to check. Without these precautions, other constituents may perceive the firms as insincere and question the validity of the philanthropic measures.

Integrative theories stress “that business ought to integrate social demands” and “argue that business depends on society for its continuity and growth and even for the existence of business itself” (Garriga & Melé, 2004, p. 52). These types of theories evoke the responsibility that a company has to better its surroundings. An important theory, issues management, is used by companies to identify and respond to social values, demands, and movements. By working towards the integration of societal ideals into the workplace, firms can work to eliminate future discord within the organization. The principle of public policy, in contrast, advocates for a primary focus to be on current public opinion regarding the corporate responsibilities of an organization over the philanthropic leanings of a small set of individuals or a singular company. A third integrative theory is stakeholder management, which seeks to balance and address the demands of all the various company stakeholders. Instead of relying on the media, government, activist groups, and other outside sources, firms go directly to their stakeholders for input regarding socially responsible actions to take.

Integrative theories revolve around championing the social values of the current time period and enacting corporate policies to further these ideals. However, companies must not be swayed by transitory trends and short-term philanthropic gimmicks that may not have any lasting impact. Firms need to carefully consider the values that society pushes currently and evaluate whether they wish to promote these ideals. Companies may be harmed if they are pressured into backing a philanthropic arrangement that contradicts their values or proves to be short-lived and ineffective. This strategy could weaken the financial standing of the firm and tarnish its reputation in the eyes of its stakeholders.

Lastly, ethical theories maintain that companies should “engage in CSR ... because it is the morally right thing to do” and because these “moral considerations ... on some issues take precedence over the company’s interests” (Fredericksen & Nielsen, 2013, p. 19). Organizations which back these theories value ethical considerations over all other factors and make decisions

based on their perceived obligations to society. The normative stakeholder theory holds that a company has a fiduciary responsibility to all its stakeholders and that these constituencies should be considered when making decisions, regardless of their ability to benefit other parties.

Another ethical theory is universal rights, which recognizes the inalienable rights of each person and encourages firms to support companies with whom they interface. The sustainable development theory has also gathered momentum in recent decades, as companies are urged to enact practices that allow for current financial success while ensuring the future continuation of resources. Some companies have even added an area in their financials to measure “the impact on their employees, the communities in which they operate, and the natural environment” (Harji, 2008, p. 1). Lastly, the common good approach asserts “that business, as with any other social group or individual in society, has to contribute to the common good, because it is a part of society” (Garriga & Melé, 2004, p. 62). Companies should promote the welfare of humanity and enable individuals to live in safe, peaceful, and just conditions.

Companies following ethical theories are usually very successful in creating sustainable proposals that benefit the people in their communities. By acknowledging the firm’s role in society and considering the needs of various stakeholders and the community, a company can enact clear and effective objectives that improve the lifestyle of the people in the community. However, if businesses are truly dedicated to following these theories, they must be watchful of inadvertently acquiescing to the demands of the majority. A firm should uphold the local concerns associated with its business. Without a steadfast commitment by the firm, the minority stakeholders and communities will likely perceive a once resolute commitment wither into apathy.

Two of the most popular theories, the shareholder value maximization theory and the stakeholder theory, often clash regarding which is more advantageous to society. According to Jensen (2002), the shareholder value maximization theory has “its roots in 200 years of research in economics and finance” (p. 9) and affords managers a clear guideline for making decisions regarding firm strategy, a feature which is lacking in the stakeholder theory. The stakeholder theory asserts that management should consider the needs of all stakeholders, but it fails to “provide a complete specification of the corporate purpose or objective function” (p. 10). Without the guiding force of a singular criterion, such as shareholder value maximization provides, critics fault the stakeholder theory as “politiciz[ing] the corporation and leav[ing] its managers empowered to exercise their own preferences in spending the firm’s resources” (p. 10). In the absence of an external or objective measure, the preferences of the corporate board and the

managers determine the future of the company. Jensen (2002) concludes that with more than one objective, managers cannot focus on all the different stakeholders simultaneously in formulating “a reasoned decision ... [and the result is] confusion and a lack of purpose” (p. 11).

The enlightened stakeholder theory, according to Jensen, adds the focal point which is absent in the original stakeholder theory by incorporating the objective of maximizing long-term firm value. An essential principle of this theory is that a firm cannot maximize its worth without considering the many stakeholders involved in its business. This criteria, along with the analysis of stakeholder needs, affords managers a clear goal, circumventing the influence of personal preference or self-interest. By operating under a methodology that weighs “the tradeoffs that must be made among competing constituencies, ... managers and directors become accountable for the assets under their control because the value scorecard provides an objective yardstick against which their performance can be evaluated” (Jensen, 2002, p. 17). The enlightened stakeholder theory offers a robust alternative to the shareholder value maximization theory by emphasizing the consideration of all stakeholders, while simultaneously supplying the benchmark of long-term value as a gauge of corporate success.

Thesis Objectives

The focus of this thesis will be on the enlightened stakeholder theory and its divergence with shareholder value maximization. The paper will discuss the distinctions and inevitable discord between the two prevailing theories, including several historical movements that shaped their relationship, and how current governance structures operate regarding company strategy. Arguments of why the enlightened stakeholder theory is beneficial for society from a CSR perspective and why exclusively using shareholder maximization suppresses the valid needs of other stakeholders will then be examined. The paper will consider evidence regarding the harm done to non-shareholders as a result of this disregard, particularly as a result of hedge fund activism on public companies and their stakeholders. The selected examples are from a variety of different industries and regions and occurred within the past two decades, but each one contains the presence of an activist investor within a firm. This thesis does not supply any numerical analysis itself on activist intervention and the problems with shareholder value maximization. Instead, it focuses on relevant information and data gathered from other researchers and presents from a socially-responsible lens several real-world examples of the ill effects of considering only the shareholder.

Conflict of Enlightened Stakeholder Theory and Shareholder Value Maximization

A force threatening to diminish the value of the enlightened stakeholder theory and other ethical CSR theories in the eyes of corporate leadership is short-termism, which has grown increasingly common within recent years as shareholder maximization has become the primary goal of many firms. According to Krehmeyer, Orsagh, and Schacht (2006), short-termism is the “excessive focus of some corporate leaders, investors, and analysts on short-term, quarterly earnings and a lack of attention to the strategy, fundamentals, and ... long-term value creation” (p. 3). With the stockholder often being the central consideration for firms when making business decisions, the pressure to garner returns during the shareholder’s relatively short ownership period is high. Companies place the desire to meet quarterly-earnings goals over improved technology, better employee training, additional hiring, and research and development. In fact, a survey of more than 1,000 board members and company executives revealed that “seventy-nine percent [of companies] felt especially pressured to demonstrate strong financial performance over a period of just two years or less,” while “[e]ighty-six percent declared that using a longer time horizon to make business decisions would positively affect corporate performance ... including strengthening financial returns and increasing innovation” (Barton & Wiseman, 2014). Because public companies are “responsible for a third of all private-sector employment and half of all business capital spending” (Dimon & Buffet, 2018), the impact of short-termism has a far-reaching effect.

Many companies feel the pressure from investors to meet or exceed their quarterly earnings target in order to increase returns for the shareholder, even if it comes at the cost of creating long-term value. Graham, Harvey, and Rajgopal (2004) reported that in a survey of 400 executives published in the *Journal of Accounting and Economics*, 80% responded that they would “decrease discretionary spending on R&D, advertising and maintenance ... to meet an earnings target” (p. 32, 35), while 55.3% said that they would “delay starting a new project to meet an earnings target, even when such a delay entails a small sacrifice in value” (p. 35). The willingness of executives and managers to sacrifice value creation in favor of “accounting driven metrics that are not fully reflective of the complexities of corporate management and investment” (Krehmeyer et al., 2006, p. 3) is a worrisome trend. John Bogle, the founder of the investment management firm Vanguard Group, stated that the goal of company management should not be “beating abstract numeric estimates but improving the operations and long-term prospects of organizations” (Bogle, 2005, p. 43). This industry-wide, short-term focus has negatively impacted many stakeholders,

especially those stakeholders who have become voiceless because of the current governance structure.

A company has many different stakeholders, including stockholders, employees, customers, suppliers, institutional investors, and the communities where the companies are located. These groups have a vested interest in the company's success and in some way depend on the company's existence for their financial well-being. According to the enlightened stakeholder theory, company leadership has a corporate social responsibility to create long-term value for the company, while keeping all stakeholder interests at the forefront. However, current corporate governance policies, heavily influenced by the short-term focus on profitability, have been overly biased toward shareholders at the expense of other stakeholders. Large shareholders such as institutional investors have little interest in a company aside from stock price gains, and their oversized influence drowns out the voices of the stakeholders with the most to lose. With increasing frequency, the interests of non-equity stakeholders, which are often more long-term focused, are being pushed to the side as board members and company managers feel increasing pressure to meet the quarterly financial expectations of shareholders and analysts.

The discord between the long-term focus of the majority of stakeholders and the short-term obsession of many stockholders was not always so stark. When public companies became common in the early 1900s, most stockholders had minimal interest in receiving large returns. They were often managers, employees, and members of the community, who had an inherent investment in the "sustainable success and growth of the company's business operations over the long term" (Rosenblum, 2017, p. 540). Holding shares for extended periods of time, they believed that "companies had a purpose beyond making money for shareholders ... [which included helping] society, and that, in part, is what investors were buying a piece of" (Semuels, 2016).

In his 2017 article "Who Bleeds When the Wolves Bite," Delaware Supreme Court Chief Justice Leo Strine discusses how a corporation's long-term profitability "tended to create more jobs, pay workers better, and create positive externalities for the communities within which they operated" (p. 1871), emphasizing the payoff of a durable focus. Companies had a regional and national focus, and "their managers, directors, employees, lenders, and even stockholders often had ties of loyalty to those communities" (Strine, 2017, p. 1871). In addition, "corporate managers tended to live in the community where the corporation was headquartered" (Strine, 2017, p. 1871) and had an active hand in its affairs, further accentuating the long-term interest that executives had in the company's continuity and well-being, as well as their protection of other constituencies.

However, in 1970, Milton Friedman published an article in the New York Times which drastically influenced the social responsibility lens under which most companies had operated previously. Friedman argued that managers had the sole obligation to “shareholder value ... [and] to maximize the value of the enterprise” and were only “bound by economic rules” (Falck & Heblich, 2006, p. 249). Therefore, consideration of constituencies aside from stockholders, as well as CSR measures, had no place in the management of a corporation. His shareholder value maximization viewpoint gained great popularity among businesses and spurred on the ever-increasing focus on stockholders over all other constituencies in the decades which followed.

The shift toward maximizing shareholder returns at all costs has caused a significant change in the makeup of company stockholders. Barton and Wiseman (2014) found that institutional investors owned “73 percent of the top 1,000 companies in the United States, versus 47 percent in 1973.” The majority of company stock is no longer owned by members of the communities where a company is located or by its employees, but rather by institutional investors and hedge funds with few community or national ties. These large entities represent “the capital of largely silent human investors ...” (Strine, 2017, p. 1872) who have become bystanders in the power struggle of the corporate world. The most involved and outspoken shareholders tend to be those with “investment strategies most in tension with the efficient market hypothesis” (Strine, 2017, p. 1872) who have no interest in the welfare of the company, other than the profit they can make by changing the current capital structure or corporate leadership. In addition, the correlation between increased company profitability and gain by the corporation’s employees and community as a result of this profitability has shrunk, as companies refuse to distribute “productivity gains with workers ... and [focus] on offshoring and job and wage cuts as methods to increase profit” (Strine, 2017, p. 1872).

Many corporations argue that they take the best interests of constituencies outside of stockholders very seriously, but evidence from corporate law suggests otherwise. While the majority of states have constituency statutes that “authorize directors to take into consideration not only the interests of shareholders, but also the interests of other stakeholders ... [such as] employees, suppliers, customers of the corporation or its subsidiaries, ... the communities and society in which the corporation resides ... and the economy and state of the nation” (Velasco, 2006, p. 462), no state has provisions for enforcing the rights of these other constituencies. States only specify that managers “may consider the interests of nonshareholders” (Velasco, 2006,

p. 463). The sole constituencies who have any legal power are the stockholders, which results in little incentive for managers to consider other stakeholders or their long-term perspective.

The current corporate governance system has profoundly influenced the willingness of corporate executives to place importance upon other stakeholders' interests. Strine (2016) argues that it is difficult for executives to "subordinate the best interests of stockholders to that of other corporate constituencies unless the stockholders themselves support that subordination" (p. 10), which would be very unlikely. Corporate managers, in a recent survey discussed by Barton and Wiseman (2014), state that the strong pressure to deliver on financial earnings "stemmed from their boards," but board members countered that they, in turn, were pressed by "investors, including institutional shareholders" to deliver superior results. These institutional investors, with whom millions of individuals entrust their savings, have increasingly shifted their focus to short-term payoffs, instead of aligning their cash flows with the long-term horizons of their clients. Because institutional investors hold a significant amount of public stock, their focus on short-termism and quarterly earnings have led to a rise in hedge fund activism.

Hedge fund activism has become increasingly common since the financial crisis in 2008 and is now a prominent force within the public sphere. Since the evolution of public companies, investors have sought to influence corporate managers and boards to deliver consistent profits and to protect their interests. Investors, especially institutional investors, initially began to engage in "soft activism" in an effort to diminish the power of the board, whom they felt were "generally ill-equipped, and unlikely, to pressure management" (Allaire, 2015b, p. 5). The increasing attacks on corporate boards by institutional investors diminished the original trust that investors placed in the board members' discretion, many of whom had years of experience working with the organization and who understood the company's products and services. These attacks "consolidate[d] the board's dependence on management's vastly superior information, expertise, and experience" (Allaire, 2015b, p. 5) and solidified the breach between the board and corporate management. As a result, board members were often less familiar with company operations and industry considerations, which prevented them from acting as the effective check on management that they once were. In the past ten years, institutional investors have begun to back the "hard activism" tactics of many hedge funds and activist investors, in an effort to force management to comply with stockholder demands.

The focus of activist hedge funds and activist investors is to maximize the stockholder value of a company that they view as underperforming. After gaining a sizable share in the

company's stock, they concentrate on boosting "returns by influencing a corporation to change its capital structure or business plan" (Strine, 2017, p. 1886). Activists argue that "they know how to unlock shareholder value better than a company's board or directors do" (Semuels, 2016), and they present a strategy to increase company value, which often targets cutting costs and increasing payouts to stockholders. They "push companies to make more disciplined use of cash and capital" (Allaire, 2015b, p. 4) by returning excess cash to stockholders via repurchases or additional dividends, increasing debt in order to decrease the cost of capital, spinning off divisions, or selling the entire company "when they believe a prospective buyer would pay a substantial premium" (Allaire, 2015b, p. 4). These hedge funds and individuals champion their ability to see the company's financial and strategic status through "an external, uncompromising perspective ... unhindered by the company's tradition, history and values" (Allaire, 2015b, p. 4). In the past, activists usually targeted companies with "ethical and legal difficulties" (Strine, 2017, p. 1890), as well as serious financial struggles. However, Strine (2017) states that the majority of companies targeted now are profitable but "pay out less of their profits than the industry average and have strong cash flows and balances" (p. 1891), becoming a "value buy" for the activists. The extra capital that can be obtained by better utilization of resources can then be allocated to the shareholders of the company.

The strategy behind investing decisions and timing differs significantly between a typical investor and an activist investor, as activist investors tend to take a short-term approach. The majority of investors invest in a company that they believe has strong long-term value and "only become active when they become dissatisfied with the corporation's management" (Strine, 2017, p. 1892). By contrast, activist hedge funds identify "underperforming" companies and only enter into an equity stake after forming a strategy to alter the structure of the company in "a manner that the hedge fund believes will cause its stock price to rise" (Strine, 2017, p. 1892). Activists need this increase to occur quickly, since the average holding time for these hedge funds is 1.8 years and "half of activist investments last slightly less than nine months" (Strine, 2017, p. 1892). Research done by S&P Global Market Intelligence revealed that "40 percent of activist investors either reduce or completely relinquish their positions in the target company in just a quarter after making investments" (Guarino, 2017). These short holding periods conflict with the timeline of the majority of stakeholders, raising the question of whether activists are actually concerned with the long-term growth of a company or simply using hit-and-run tactics to artificially inflate the stock price in order to "make a quick return with minimal investment" (Guarino, 2017).

Ongoing debate continues across the academic community about whether the aggressive hedge fund activism that is prevalent within our society is good for stockholders. Strong evidence exists which suggests that these ventures are not beneficial to most stakeholders. The hedge fund advocacy group AIMA (Alternative Investment Management Association) states that these investors “seek higher standards of corporate governance, which improves alignment of interest between management, shareholders, and all other stakeholders” (Malik, 2015, p. 4), ultimately leading to better company performance and increased efficiency for everyone. However, Strine (2017) points out that “if the proponent of a strategy with long-term effects has no intention to hold and suffer the risks of that strategy, there is naturally less reason for that proponent to concentrate on the long term” (p. 1907). Despite the claims of activist investors and hedge funds to be focused on both the long-term and short-term outlook, their intentions come into question when comparing the timeline of their investments with that of the interests of stakeholders they represent.

From the very beginning of an activist’s intervention, the goal is to obtain an equity position within a company in order to enact changes which result in a stock price increase. Strine (2017) discusses how several hedge and mutual funds will often join the lead activist in silently accumulating an equity position within the target company, often unbeknownst to the board and CEO. Once this “pack” of investors forms, they must disclose an equity stake of more than 5% within ten days of acquiring this level of ownership in a 13D filing. When the position becomes public, a spike in the stock price generally occurs, as the market reacts to the potential of additional increases if the hedge fund gains control or extracts a settlement from management. While this price increase benefits equity holders, it does not reflect any long-term growth creation and is frequently viewed as a form of financial engineering.

The methods used by activists to achieve their desired governance changes can range from a simple change in board or corporate leadership to the takeover and sale of a company. Activists usually attempt to convince the company management and board to comply with their ideas. They are often successful in gaining “some degree of representation on the company’s board” (Strine, 2017, p. 1903), allowing the hedge fund an active voice within management. However, if the corporation’s leadership refuses to cooperate, the activists then escalate the attack in order to gain traction within the target. The hedge funds may try to obtain a large equity position within the company or “obtain support of pension funds and institutional investors, who can pressure the board and management as large shareholders” (Guarino, 2017). They can also utilize other

approaches to pressure management such as “proxy fights ... [and] ‘withhold vote’ contests” (Strine, 2017, p. 1903), as well as legal action and hostile takeovers. These tactics are often very costly for the target company financially and strategically. Management is forced to focus on the activists’ involvement instead of the firm’s continued success, making the firm vulnerable to market and economic adversity.

As a result of many activist interventions, these investors and hedge funds have created significant “transfer[s] in wealth from society as a whole to equity investors” (Strine, 2017, p. 1947), which ultimately acts to the detriment of the majority of stakeholders. These wealth transfers are often initiated through demands to increase stock buybacks and dividend paybacks to investors. While many scholars argue that dividends and repurchases can help stimulate the economy, Washington University’s Steven Fazzari points out (as cited in Monga et al., 2015) that most of the equity of public companies are “owned by the wealthy, who tend to save more of their income ... [while] many kinds of business investment - from building construction to equipment maintenance and purchases - involve payments to contractors and suppliers who pay wages to middle and low-income workers.” The stock repurchases and dividend paybacks ultimately come at the expense of the majority of stakeholders who depend on public companies’ long-term investment in factories, production equipment, and research and development (R&D). Even large companies, such as Apple and Dupont, are pressured by activists to distribute their cash reserves, often at the expense of research and development. Many activists view their target’s allocation to R&D as excessive and argue that it should “pay out more gains to investors immediately” (Strine, 2017, p. 1901). In many ways, this approach undermines the fabric of American corporations, who have long relied on significant investment in innovation to maintain their competitive status and create sustainable value for their stakeholders.

The slashing of research and development in order to maximize the profitability of shareholders comes at a price, often from those individuals tied to the long-term success of the company. Activists often engage in asset stripping in firms that invest highly in R&D, selling product information and materials used in various patents in order to extract immediate value, frequently at the expense of the long-term success of the company. Patents that may have taken years of intense study, careful experimentation, and detailed preparation to file are hastily sold, in order to make a quick profit. This valuable knowledge could have been utilized by the company for further development, resulting in additional successful products. However, because of the cursory focus of the activist, this potential value is lost because of the decline or complete

discontinuation of its research, hurting the many stakeholders who rely on the company's continued innovation. Lawrence Fink, the CEO of BlackRock, stated (as cited in Semuels, 2016) that "a company can stop R&D and show fabulous short-term results ... but over the long cycle, that's devastating for the company and ... probably for the United States as well." Yvan Allaire and Francois Dauphin found in a 2015 study that companies targeted by activists decreased their research and development spending from an average of 17.34% to 8%. While companies must balance their R&D with other areas of company expenditures, activists need to recognize that the decision to dramatically decrease this spending comes at the cost of new technology and patents, ultimately harming the value of the company.

Much of the prior success of these profitable target firms has been the result of a significant investment in R&D, since these companies typically maintain lower free cash flows. A company which adds a substantial amount of debt dramatically escalates its likelihood of financial distress in the case of market adversity. When activists call for an increase in the leverage of a firm, the company becomes vulnerable to a "loss of jobs through insolvencies, economic shocks such as financial crises, and reduction in value of debt securities" (Strine, 2017, p. 1883). The demand for greater leverage, along with the other concessions required, leaves many target companies gasping for breath after the intervention. Companies are left crippled with "no slack resources, a curtailed ability to invest for the long-term, no diversification of activities to shield the company from industrial sector variations ... [and] no buffer for economic downturns" (Allaire, 2015b, p. 12). The increase in the debt-to-equity ratio of these target companies results in a higher probability of financial distress.

The demands of activists also result in wealth transfers from bondholders, who suffer as a result of the corporate governance changes demanded. These changes often involve increasing leverage and decreasing free cash available, in order to utilize this capital as payouts for stockholders. However, the amount of leverage and free cash flows of a company are the primary factors used by bond rating agencies. The increase in debt-to-equity ratios, cash flow reductions, and payout ratios required by activists usually causes a decrease in ratings. Moody's rating agency stated that the "effect on the creditworthiness of Moody's-rated issuers is almost universally negative ... [and that they have seen numerous] concessions to activists that have eroded credit quality contributing to downgrades" (Byrd, Hambly, & Watson, 2007, p. 1). In a study by Klein and Zur (2010), 29.4% of target companies had their bond ratings downgraded within one year of a 13D filing, and 49.4% discontinued their rating process. As the risk for a firm increases with

higher leverage and fewer cash flows allocated to R&D, the price of bonds and the “value of its investment-grade corporate debt drops significantly” (Allaire, 2015b, p. 11). Klein and Zur (2010) found that the corporate bond prices of targeted companies fell an average of 8.19% after a 13D filing, resulting in a significant reduction of bondholder value.

Arguably, the stakeholders harmed most by activist investors and hedge funds are the labor force and communities of the target company. Strine (2017) states that for the “stuck-in human investor” who depends on the corporation’s long-term success, the increased dividends and payouts come at the expense of “developing new products or services, which involve the prospect of greater employment opportunities and growth in the future” (p. 1939). These individuals derive their wealth from their wages and the continuing existence of their company, not from temporary stock price increases. These human investors with their long timeline are the main stakeholders who feel the effects of activism and who must “not only ride the bubble up ... but also ride it back down to a bottom that may be lower than would have been the case” (Strine, 2017, p. 1885) without intervention. In recent years, an increasing divide has emerged in the distribution of profits between labor and stockholders, exacerbating the “income inequality that reduces the wealth of many to benefit the few” (Strine, 2017, p. 1942). Success that comes at the expense of the labor force ultimately harms the majority of stakeholders in both short- and long-term outcomes.

The negative impact on labor manifests itself in many ways, including quality of life and financial well-being. Even Brav, Jiang, and Kim (2013), major proponents of hedge fund activism, admitted that “target firm workers do not share in the improvements associated with hedge fund activism ... [and] experience a decrease in work hours and stagnation in wages” (p. 22). They also suggested that the increase in the stock price is likely coming at the expense of the labor force in the form of “labor rents,” implying that shareholders are profiting not only from an increase in stock price but also from the employees of the company. The employees are the primary individuals who feel the short-term and long-term impact in corporate governance changes. They suffer from the short-sightedness of activists and bear the repercussions to the company’s competitiveness and innovation long after the hedge funds exit.

Intervention by activists and hedge funds regularly leads to significant layoffs, hurting not only the employees but the surrounding communities. In the 2015 study conducted by Allaire and Dauphin, they found that the companies targeted by activists advocating for cost reduction or asset restructuring saw a 20% decrease in employment over the following five years. This downsizing either came as a result of the decision to close domestic facilities and to offshore jobs to countries

that offered cheaper wages or because of mergers, sales, or spin-offs that eliminated the need for employees. Such layoffs can hollow out entire communities, ruin local economies, damage the financial stability of other businesses tied to the target's success, and force a mass exodus of employees toward other jobs. In some cases, companies taken over by activists have threatened additional layoffs or relocation to other states unless local and state governments provide subsidies, loans, and grants to the company. The decrease in employment, the languishing of towns who rely on the target company, and the excessive leverage exerted over states and local communities demonstrate an underlying disregard for the human investors.

The method used by activists to bring about the most substantial gain to shareholders is the whole or partial sale of the target. Activist hedge funds will occasionally argue that if a company is separated into smaller sections, they can unlock value the value of a company. They believe that if a company acts as a pure play, it can focus on its most profitable operations and gain a significant market share, while minimizing distraction from less profitable areas. Hedge funds, unlike private equity funds who purchase a company with their own financing, do not want a long-term commitment and instead welcome the opportunity to exit their equity position in the target through a "merger with a lucrative target-side premium" (Strine, 2017, p. 1902). Activists often push target companies to sell themselves and will make governance changes which include layoffs, wage decreases, and the closing of facilities to inflate the sale premium, in the hopes of providing a better payoff (Strine, 2017, p. 1945). An interesting phenomenon noted by Brav, Jiang, Thomas, and Partnov (2008) is the lack of symmetry in this context, since only 2.4% of hedge fund activism involved the activist attempting to block a pending acquisition or demand better terms. Even if the activist did not push for a spin-off or sale, the target still became more susceptible to being sold or incurring financial distress. Allaire and Dauphin (2015) found that just four years after an activist attack, 45.2% of firms cease to exist because of mergers, liquidations, and bankruptcies, and private equity funds acquire 22.4% of the companies who are sold. Such evidence suggests that activists use the sale of their target as a means of boosting returns for themselves and stockholders at the expense of other stakeholders and their communities.

The most common demands of activists are board representation and a change in company management, which often hurts other stakeholders in the long-term. Board representation grants activists a "foot in the door," allowing them to influence strategy and gain traction within the company. In their 2015 study, Allaire and Dauphin also noted high CEO and CFO turnover rates in companies targeted by activists, soaring as high as 27% in the first year. Replacing a CEO is a

major victory in an intervention, because it gives a clear signal to the board and the target that the activist now has the upper hand in the direction of the company. Most stakeholders tied to the continued viability of a company desire a leader with experience in their industry who has a strategy that avoids delivering “paper profits that are not indicative of economic reality or leverag[ing the company] ... at the cost of future insolvency” (Strine, 2017, p. 1884). Even Brav, Jiang, Thomas, and Partnov (2008) concede that most hedge funds are “not experts in the specific business of the target firms” (p. 1755), instead bringing a financial perspective at the expense of an operational focus. Activists targeting a company within an unfamiliar industry may not have the expertise to guide the firm successfully or to fully understand the timeline needed to achieve sustainable profits. The fear that activists do not “have sufficient knowledge or experience in that particular industry or about the company” (Guarino, 2017) leads management to resist intervention, resulting in more aggressive actions by the activists to gain control. Stakeholders must always be wary of management-entrenchment. However, they rightly value the expertise that many managers and board members bring to the table and have reason to fear a disruption in the long-term success of a company brought about by activists unfamiliar with the industry.

The fear of activism has caused a disturbing trend across many public companies, who take actions to minimize the likelihood that they will be targeted. Coffee and Palia (2015) found that firms, especially in industries such as pharmaceuticals and technology, are “more likely to take preemptive steps to cut research expenditures” (p. 580) as a measure to avoid a takeover. More board members and managers have advocated for governance changes similar to those of activists, including higher dividend payouts and stock buybacks. Because of the increasing regularity of hedge fund interventions, company leadership is encouraged to “examine their company as seen through the eyes of activist hedge funds and implement measures they would likely urge on company management” (Allaire, 2015b, p. 13). These measures include a reduction in hiring, less investment in technology, and slashing research and development, all in an effort to hit quarterly-earnings which are often subject to factors beyond the company’s control. Krehmeyer, Orsagh, and Schacht (2006) reported that more than 50% of companies “would delay new projects, even if it meant sacrifices in value creation” (p. 3), while research by Strine (2017) noted that managers “admit to refusing to do projects with very positive long-term prospects because [of] ... reductions in GAAP earnings in the near term and ... feared negative immediate stock market reaction” (p. 1943). These defensive actions demonstrate the secondary impact that activism has on

management's willingness to engage in activities that would benefit non-shareholders and the company's future direction.

In cases when activists have successfully filled board seats, but their governance changes are not implemented or successful, some activists may use "greenmail" as payment for the hedge fund to exit the company. This payment involves buying out the activists' shares at a significant premium over the current stock price (Berke & Demarzo, 2017, p. 588). Greenmail is hotly debated, as many shareholders feel that the company management "confers upon the fund a premium" (Strine, 2017, p. 1906) at the expense of equity owners. This concession by the target company to eliminate the influence of activists speaks to the desperation that many company leaders feel when attempting to remove the hedge fund. The company may view this measure as a necessary step in order to maintain viability and meet its long-term goals, while at the same time recognizing the harm it inflicts upon the stakeholders of the company.

Though often lauded as delivering superior results, the track records of activists show otherwise. Hedge funds regularly fail and are liquidated, but the hedge fund community often reports an inflated estimate of industry returns by ignoring the poor performance of defunct firms. Hedge funds have "an average lifespan of 5 years," and previous data revealed that "within three years, a third of all funds disappeared" (McCrum, 2014). These statistics are alarming for companies whose capital and livelihood are most affected by activist investment strategy. Most of these strategies are in stark conflict with the Efficient Market Hypothesis, which espouses that "an active trading strategy dependent on outguessing the collective judgments of the market is unlikely to succeed" (Strine, 2017, p. 1883). As more hedge funds focus on targeting profitable companies in an effort to squeeze out additional value for shareholders, Strine (2017) notes that there is less reason to believe that "they are making the economy much more efficient and more reason to be concerned they are pushing steady producers of societal wealth on a riskier course that has no substantial long-term upside" (p. 1932), while at the same time harming themselves. According to a study done in 2015, activists underperform against their benchmarks on a risk-adjusted basis (Getmansky, Lee, & Lo, 2015). The narrow, short-term view that activists take in their efforts to beat the market often results in a struggle to meet the profitability benchmarks set for themselves, as well as the demise of their target.

The threat of intervention and the pressure to meet quarterly-earnings has led some companies to take their company private or to avoid going public at all. The decrease in public companies harms the "average investors who wish to diversify their holdings and achieve better

long-term results” (Guarino, 2017). According to Dimon and Buffet (2018), these actions have deprived “the economy of innovation and opportunity ... [while also decreasing] opportunities for retail investors to create wealth through their 401ks and individual retirement accounts.” While companies that choose to become private have more freedom to focus on the future of their operations and goals, average investors and societal stakeholders suffer from the loss of potential innovation and economic growth which was stifled by the fear of activist intervention.

Not all companies have the desire or funds to take themselves private or to enact the changes demanded by activists. Many businesses use other methods to avoid a hostile takeover by activists, including the use of staggered boards, the poison pill, and supermajority voting. While some companies still employ these measures, such strategies are becoming increasingly less common, as corporate governance trends swing towards protecting shareholder interests over all other stakeholders. In particular, staggered boards have come under extreme scrutiny and are often deemed as leading to entrenchment. However, staggered boards have proven very useful to companies facing a hostile takeover, since the activist can only acquire the board seats available for re-election that year, in contrast to a declassified board where all the current board members can be removed simultaneously and replaced with individuals of the activist’s choice. Coffee and Palia (2015) reported that “serious academic research now supports the view that staggered boards can provide stability and continuity that enhances shareholder value” (p. 603), especially in companies with heavy R&D who rely on a long-term focus.

Another protective measure against activist intervention is enacting a poison pill, which when coupled with a staggered board, is one of the strongest defenses for a targeted company (Berke & Demarzo, 2017, p. 948). A poison pill allows the target to offer stock at a deeply discounted price to all shareholders except the activist, in order to dilute the stake of the activist. This weakening of the activist’s value makes the takeover “so expensive for the acquiring shareholders” (Berk & Demarzo, 2017, p. 946) that the activist usually halts the takeover bid. The use of these defensive tactics forces activists to reevaluate their strategy and may ultimately protect stakeholders from a devastating intervention into the company’s long-term goals and strategy.

If the activist’s position or influence is too powerful, many companies resort to calling on a white knight or squire to avoid a takeover. A targeted firm may identify another company willing to acquire or take a significant stake in the firm. A white knight is a company that comes to the rescue of the target and agrees to acquire the firm in order to stop a hostile takeover by an activist. The white knight makes a “more lucrative offer than the hostile bidder” (Berk & Demarzo, 2017,

p. 948), forcing the activist to back down. While the target is ultimately relinquishing control of its operations to its new acquirer, the leadership hopes to preserve some of the company's long-term value and goals from the activist's potential structural and strategic governance changes.

Another defensive variant for targeted companies is engaging with a white squire who will buy a "substantial block of shares in the target with special voting rights" (Berk & Demarzo, 2017, p. 1947), in order to stop the hostile raider from gaining control of the company. This purchase is made with the understanding that the white squire will not "choose to exercise its control rights" (Berk & Demarzo, 2017, p.1947). If the targeted company feels that the activist is advocating for change that does not fit with the long-term goals and strategy of the company, a white knight or squire can protect the firm and its stakeholders from the threat of these changes.

As hedge fund activism increases, serious consideration is justified for the effects on the many stakeholders who rely on public companies for their employment, wages, and long-term financial security. In particular, institutional investors, who represent the capital of the average American, have an ethical responsibility to the millions of people who invest their livelihoods within the funds of public companies and rely on their responsible stewardship. The partnership between institutional investors and hedge funds began in 1996 when the National Securities Market Improvement Act was passed, allowing large entities such as pension funds, endowments, and foundations to invest in hedge funds (Semuels, 2016), providing upward momentum for hedge fund growth. In 2003, the Securities and Exchange Commission (SEC) passed a law requiring institutional investors to "disclose how they voted in company elections about governance ... and outlin[e] ways in which ... the vote was in the best interest of clients" (Semuels, 2016). Because these large funds did not understandably research every company in which they invested, they hired proxy advisory firms to do this research and to vote in their interests. These proxy firms tended to "support activist campaigns ... and often side with hedge funds, rather than company leadership" (Semuels, 2016). This decision to contract out voting rights cost institutional investors much of their involvement with the public companies and gave hedge funds almost complete control. A survey done by FTI Consulting (2015) revealed that 76% of institutional investors had a favorable view of activist investing, and 84% agreed that they added value to target companies. Strine (2017) states that institutional investors take on "substantial risk from making investments about which they know too little ... and regularly expose human investors and society as a whole to the risks that come with hedge fund investing" (p. 1935-1936). Considering that the majority

of hedge funds last less than five years, this trend is extremely troublesome, especially for stakeholders relying on investments which mature decades in the future.

The amount of money invested in hedge funds by endowments and pension funds has increased over the past decade, especially after the 2008 recession. These institutional investors were struggling to recoup the money they had lost during the financial crisis, and they saw hedge funds as a way of “using above-market returns to fill a hole left by previous underinvestment and poor investing” (Strine, 2017, p. 1936). A report published in 2015 found that pension funds alone contributed at least 40% of the capital invested by hedge funds (Strine, 2017, p. 1895). This huge stake demonstrates the level to which institutional investors, including pension funds, charitable foundations, and university endowment, have bought into the strategies championed by hedge funds. However, these institutional investors chose to ignore the reality that they were robbing the very individuals who they were representing. As Strine (2017) points out, “the human investor ... bears the risk of investment losses” (p. 1936) by these activist strategies that often fly in the face of logical financial theory. The human beings, hidden behind the façade of the money they invest, rely on the “durable appreciation of their portfolio, and do not benefit in any way from stock bubbles arising from gimmicks or unsustainable strategies because these gains will go away” (Strine, 2017, p. 1879), leaving these individuals at the mercy of macroeconomic conditions.

Examples of Activist Intervention

The Intervention of Trian Fund Management within Dupont

Perhaps the most well-known activist intervention in the past decade is the attempted takeover by Trian Fund Management of the Delaware-based chemical company Dupont in 2014. Trian, led by Nelson Peltz, demanded that DuPont, a “highly profitable firm that had consistently outperformed all relevant benchmarks for corporate performance” (Coffee & Palia, 2015, p. 555), increase its share price, cut costs, and replace key board members with Trian representatives, including Peltz himself. In addition, Peltz advocated for the separation of several of Dupont’s sectors into independent companies. DuPont eventually spun off its chemical business into Chemours, but the company resisted additional spinoffs and board changes. Trian and DuPont then began a costly and highly-publicized proxy battle, each side appealing to shareholders for support. DuPont’s management argued that maintaining their long-term investment in research

and development was “in the best interests of typical American investors whose money is stuck in the market for decades and who depend on sustainable long-term growth fueled by deep investments in research and development” (Strine, 2016, p. 19). DuPont’s board candidates narrowly defeated Peltz and the rest of Trian’s nominees with the help of several money managers (Strine, 2016).

However, Dupont’s victory was short-lived, as the proxy fight proved incredibly costly, resulting in an inability by Dupont to meet its earnings benchmarks. The DuPont CEO resigned and was replaced by Ed Breen, who announced that DuPont would merge with “its industry rival . . . Dow Chemical Company, and then break the combined company into three pieces” (Strine, 2016, p. 24). Since this fragmentation was ultimately the goal of Trian, the hedge fund viewed this “transformative transaction . . . [as] a great outcome for all shareholders” (as cited in Bunge, Benoit, & Dulaney, 2015). Strine (2017) questions whether the financial engineering of “two huge science corporations becoming one in order to then become three” (p. 1949) was ultimately in the best interests of the companies. What is certain is that a select few individuals gained incredible amounts of money in the merger at the expense of the average American worker. As a result of downsizing operations, Dupont employed “at least 1,700 fewer workers, many of whom were skilled scientific researchers and technical workers” (Strine, 2017, p. 1949), leaving a trail of devastation for families, communities, and entire regions.

The Coercion of States by Dow Dupont Leadership

In addition to employee layoffs and closure of facilities within the original community, activist intervention has indirect consequences. Often under the new leadership of the activist, companies pressure communities and states to grant favorable tax incentives, in exchange for keeping jobs within the area. For example, when DuPont merged with Dow and broke into three separate companies, these new businesses threatened to relocate unless their states of residence, Michigan, Delaware, and Iowa, provided an incentive to stay. Ultimately, these states conceded to the requests of the companies, decreasing corporate taxes for these particular businesses and burdening other taxpayers with the collective cost (Strine, 2016).

The Privatization of Dell in 2014

Hedge funds and activists often instill fear within public companies, and many managers react with steps to decrease the likelihood of acquisition. Other businesses mitigate this risk entirely by choosing to remain private or becoming private. A prime example is the computer technology company Dell, which in 2013 went private. In 2014, CEO Michael Dell published an article in the Wall Street Journal, affirming his decision to take the company private in order to have “the freedom to focus first on innovating for customers in a way that was not always possible when striving to meet the quarterly demands of Wall Street.” While the company operated in the public sphere, Mr. Dell noted that innovation and research often suffered in striving to meet earnings benchmarks. However, after the company became private, a “small group of vocal investors [was no longer] hijack[ing] the public perception of our strategy ... [at the expense of] building for the future” (Dell, 2014). In the long run, the fear of companies to become or remain public harms the average consumer and stakeholder, since less innovation and economic growth result from the loss of potential investments.

Activist Pressure on Large Established Companies

The backing of institutional investors has allowed activist hedge funds to target more prominent companies each year, and this trend shows no sign of stopping. With more assets under their control, activist hedge funds can increase the stake in their targets and put additional pressure on management and boards. Large and successful companies, such as McDonald’s and Apple that once seemed out of reach, are becoming easier targets for hedge funds, who rely on institutional investors to finance their attacks in spite of their short-term horizon. In 2015, several hedge funds seized a sizable stake in McDonald’s and demanded a greater dividend payment to shareholders. McDonald’s eventually succumbed to the pressure, “borrowing \$10 billion to finance \$30 billion in dividend payments to shareholders” (Guarino, 2017). In 2013, activist Carl Icahn bought a large number of Apple shares and pushed for a stock buyback in order to increase shareholder value, stating that “there is nothing short term about my intentions here” (Icahn, 2013). However, Icahn exited his position in the company three years later, reinforcing the distrust of activists who often hold their position just long enough to realize the returns they demanded from their target company.

The Intervention of White Tale Holdings within Clariant

Another distinct example of the short-term focus of activists is the attack by the U.S. hedge fund White Tale on the Swiss chemical company Clariant and subsequent stake sell-off to Saudi Arabia's Sabic group. White Tale disrupted a merger between Clariant and Huntsman Corporation in late 2016, coming public with a 24.9 percent stake in the company. The hedge fund then demanded board representation and a strategic review of the company, "describing itself as 'long-term investors'" (Atkins, 2017). Clariant rejected this claim, saying that White Tale was "merely focused on finding bidders ... with the ultimate consequence of breaking up the company and selling the assets" (as cited in Atkins, 2017). Little more than three months later, White Tail exited their position by selling its shares to the Sabic group. As a result, Clariant's stock price "fell as much as 11 percent ... wiping 1 billion Swiss francs (\$1 billion) from the company's market value" (Hughes, 2018). The strong influence that activists exert over such powerful companies illustrates the momentum that institutional investors have given to hedge funds.

The Closure of Wausau Paper Company by Starboard Value

With many large businesses feeling pressure from activists, smaller regional companies have little chance to fight against the demands of corporate raiders. In several stark examples, the desire to extract the highest amount of value for shareholders, even at the destruction of employment, wages, and community, is evident in the interventions by activists. In May 2011, the activist hedge fund Starboard Value began agitating for changes in the products of the Wisconsin-based Wausau Paper Company, calling on the regional firm to back Starboard's strategy "to unlock significant unrealized value for shareholders" (as cited in Schmid, 2011). Starboard claimed that as the "largest shareholder of the company, our interests are directly aligned with those of all shareholders" (as cited in Schmid, 2011) and demanded board representation. Ultimately, Wausau conceded to the demands of the hedge fund and closed its mill in Brokaw, Wisconsin, eliminating 450 jobs in the community. According to estimates, the facility closure would "drain more than \$72 million annually from the central Wisconsin economy ... [and lead to] the loss of an additional 650 jobs in industries and [less] consumer spending" (Schmid, 2011).

Relational Investors and CalSTRS Involvement in Timken Steel

An instance of regional-level activism involved Timken Steel, an Ohio-based firm that produced steel and bearings. The hedge fund Relational Investors, backed by the pension fund California State Teachers' Retirement System (CalSTRS), maintained that Timken carried an excess cash cushion and thereby withheld value from shareholders. Relational Investors demanded that Timken split into two companies, with one business focused on bearings and the other business on steel. Company management fought back, arguing that the cyclicity of the steel business warranted the extra layer of protection for economic downturns. The bearing sector assisted in stabilizing the earnings of the profitable, but often volatile, steel business (Schwartz, 2014). Ultimately, Relational Investors was successful in spinning off the company into two separate entities, earning a large premium in the sale of its Timken's stock as it exited the two companies less than a year after the 13D filing (Schwartz, 2014). Suzanne Berger, a professor at MIT, observed the evident hypocrisy of institutional investors in their responsibility to protect the average American, noting an incredibly flawed economic system where "California teachers have to protect their pension funds by hurting manufacturing in Ohio" (Schwartz, 2014). The disregard by many hedge funds and institutional investors for the average stakeholder has left no public company safe from their demands.

Sotheby Targeted by Activist Wolfpack Approach

Often, several activist hedge funds will take a sizeable stake within their target but wait to disclose their stake publicly until the allowed ten days after the 13D filing. During these ten days, the public company is unaware of the threat it faces and has a challenging time defending against the hedge funds' demands. In 2014, the art auction house Sotheby was targeted by a group of hedge funds, including lead activist Third Point, which reported an accumulated stake in the company of almost 10% (Coffee & Palia, 2015). However, later disclosures revealed that the stake of other hedge funds in the company "brought the total ownership in Sotheby's up from 9.6% to nearly 33%" (Coffee & Palia, 2015, p. 597), which forced Sotheby's to concede to some of the requests by the hedge funds. This "wolf pack" mentality of activists harms the company's ability to prepare for confrontation and usually leads to forced acquiescence by the target to the demands of the hedge funds, even if these demands harm the majority of company stakeholders.

Pershing Square's Intervention in Zoetis and Valeant

The intervention of Bill Ackman and his fund Pershing Square into the animal health company Zoetis illustrates the potential weakening of local economies by unreasonable demands of activists. When Ackman disclosed a 10% stake in Zoetis in 2014, he demanded that the company reduce expenditures on research and development. Kalamazoo, the site of Zoetis' largest facilities, had already suffered layoffs from a series of mergers beginning in the 1990s, when Swedish Pharmacia acquired the Kalamazoo-based Upjohn Company and then in 2003 when Pfizer bought Pharmacia. With uncertainty about the future of the animal health division, Pfizer decided to spin the company off in 2013, instead of selling it. Zoetis' stock had increased by 55% since its IPO and 24% in 2014 alone when Ackman came public with his stake. Many analysts suspected that Ackman would "push the animal-health company to sell itself to a large drug maker such as Valeant Pharmaceuticals International Inc." (Benoit, Rockoff, & Hoffman, 2014) with whom Ackman currently partnered, in an attempt to acquire the drug company Allergan.

Valeant was well-known for its asset-stripping strategy, as a "serial acquirer" ... [who bought] pharmaceutical companies with established products and [cut] back on, or [ceased], their research and development efforts in order to maximize the cash flow from their established products" (Coffee & Palia, 2015, p. 577-578). The strategies of Valeant were particularly ruthless, since the CEO announced at the time of the proposed merger with Allergan that 20% of Allergan's employees would lose their jobs and research expenditures would be slashed by almost 70% (Benoit et al., 2014). Zoetis employees and the Kalamazoo community feared this intervention by Ackman, since Zoetis employed approximately 9,000 workers, many of whom would be laid off if the company was sold. To defend itself, Zoetis "adopted a one-year shareholder rights plan - a poison pill - likely to deflect a hostile takeover orchestrated by Ackman" (Weintraub, 2014). Ackman's plans never came to fruition, however, as he and Valeant were forced to pay \$290 million "to settle claims they engaged in insider trading when working together to press a takeover" (Gara, 2017) of Allergan. Ackman exited his position from Zoetis in May 2016 after his company Pershing Square saw its earnings drop 18%, mainly as a result of the massive loss after exiting their position in Valeant (Stevenson & Picker, 2016). The unrealistic and self-serving demands often made by activists during an intervention can lead to the loss of valuable research and development, massive layoffs, and the weakening of local economies.

Potential Steps to Improve Conditions for All Stakeholders

The often adverse effects of hedge fund activism on stakeholders reveal the need for significant changes in corporate governance, with an emphasis on consideration of all stakeholders regarding decisions about the future of a company. In particular, institutional investors require greater awareness of the detrimental effects of hedge fund activism from a corporate social responsibility perspective. Institutional investors, responsible for the capital of human investors, should focus on “their stuck-in, long-term perspective” (Strine, 2017, p. 1965). The short-term stance, often pushed by proxy firms, severely undermines the potential growth of companies. McKinsey reported that stock prices in the U.S. have typically “overdiscounted future returns by 5 to 10 percent” (Barton & Wiseman, 2014), leading to missed opportunities for the company and the American workers who might have benefited from the investment. Institutional investors should be much more informed when supporting recommendation of proxies for intervention in a company, since advisory firms almost exclusively side with the shareholder perspective when placing their votes.

Barton and Wiseman (2014) emphasize the importance of hedge funds clearly outlining their definition of long-term investing to their institutional investors and the steps involved in executing their goals. Institutional investors must reinforce that “short-term underperformance should be tolerated – indeed, it is expected – along the road to greater long-term value creation” (Barton & Wiseman, 2014). Pension funds, charitable foundations, and endowments must check that the long-term perspective claimed by hedge funds is evident in their portfolios. Institutional investors and hedge funds should partner with the companies in which they invest. Instead of simply selling the stock in the event of poor performance, institutional investors should “engage with a company’s executives – and stay engaged over time” (Barton & Wiseman, 2014) to develop a plan for success and commitment to achieving long-term goals. Institutional investors need to hold both themselves and hedge funds accountable for investing in a manner that benefits those whose capital they are representing.

Additionally, Barton and Wiseman advocate for institutional investors to focus on long-term metrics in the companies in which they invest and to support governance structures that reflect the timeline of the locked-in human investors. By directing attention to a company’s “ten-year economic value added, R&D efficiency, patent pipelines ... [and] multiyear return on capital investments” (Barton & Wiseman, 2014), institutional investors can appreciate the long-term trajectory of the company, instead of basing important decisions on quarterly earnings that do not

reflect the full picture. Pension funds, endowments, and foundations need to commit to this perspective and require that the hedge funds with which they partner “better grasp [the] long-term metrics and ... integrate them into their investment philosophy and their valuation models” (Barton & Wiseman, 2014). Governance practices which encourage long-term value creation are necessary, including the election of dedicated and knowledgeable board members and executives who are committed to balancing shareholder demands with the interests of other stakeholders. Measures should be enacted that work to decrease short-term pressures and increase smooth, sustainable growth for the company. In particular, these measures must be “agreed to in advance of market instability” (Barton & Wiseman, 2014), since economic downturns can lead companies to question their approach if no strategic guidelines exist. Shrewd board and corporate leadership, which will deliver positive results for institutional investors and their long-term human stakeholders, enables companies to focus on their future and operational success through evaluation of sustained performance.

Public companies should adopt measures which protect the interests of their long-term stakeholders, including regulatory and governance changes within the company that decrease the threat of activists on future value creation. Hedge funds want corporate leaders to “be risk takers, going hell-bent for equity gains, even if that [means] hurting or compromising constituencies like workers ... or communities” (Strine, 2017, p. 1925) and to reinforce this paradigm through compensation based on equity gains. This strategy all but eliminates the ability of management to consider other stakeholders or to create sustainable value for the company. Compensation should instead be aligned with “long-term performance and ... long-term client interests” (Krehmeyer et al., 2006, p. 10) and should reward managers based on sustained wealth creation, instead of wealth transfer via asset stripping. Recently, hedge funds have increased their demand for “more independent directors ... with no prior ties to the company or its indirect competitors, suppliers, or customers” (Strine, 2017, p. 1925) in an effort to control company leaders. However, removal of company loyalty, coupled with equity compensation, creates conflict for board members in balancing the interests of all stakeholders. By instituting a staggered board, companies can minimize the impact of activist demands for actions that could ravage the ability of companies to safeguard the interests of its human investors. Board members must be willing to stand up to activists if they believe that company leadership has a good long-term plan. While board and management entrenchment does not benefit anyone, the allegiance of board members to a

company's success and long-term strategy is valuable for those workers who are locked into the firm for several decades.

Regulatory changes also benefit public companies that are working to protect the interests of human investors against aggressive activist tactics. As the SEC continues to increase the amount of involvement and governance voting measures required for institutional investors, proxy firms have gained more influence over the votes cast by these large investment funds. Strine (2017) states that voting has become "too much of a 'compliance mindset' rather than a 'fiduciary mindset'" (p. 1967), allowing complacency toward the interests of long-term investors. According to Strine, permitting institutional investors to decide what votes "actually [matter] to the investment objective of their human principals and focusing their limited resources on analyzing the optimal way to vote" (Strine, 2017, p. 1967) would strengthen alignment of the two sides. Greater emphasis on "preventing investment funds from relying upon proxy advisory firm recommendations[,] unless those are tailored to the fund's investment style and horizon" (Strine, 2017, p. 1967) would also motivate proxy firms to deliver better stewardship of the capital of their human investors.

Additional governance changes have been suggested, including enhanced voting rights for long-term investors and adjustment of the window and equity stake required for hedge funds to file a 13D form. Most public companies in the U.S. utilize a "one-share-one-vote" procedure, essentially a direct democracy with no protection for the minority or voiceless stakeholders. Yvan Allaire (2015b) suggests that companies consider requiring that the "right to vote shares would be acquired only after a one-year holding period" (p. 17), curtailing the effect that the short-term outlook of activists has on the company's future performance. Public companies in the U.S. could also consider adopting the innovative measures taken by France, which "mandates double voting rights to investors who have held shares for at least two years unless shareholders vote to amend the bylaws to opt out of the rule" (Dabney, Aguilar, Levanon, & Parkinson, 2015, p. 5). The policy encourages shareholders, including hedge funds and institutional investors, to commit to wealth creation and innovation within a company, instead of merely extracting value at the expense of other stakeholders. Although these changes need to be coupled with straightforward and thoughtful design to minimize empire-building and entrenchment, they could ultimately curb strategies which conflict with sustainable growth.

Concern regarding the tactics employed by hedge funds when gathering a stake within their target has led many experts to advocate for change in the disclosure procedure. The current

regulation requires that investors accumulating a 5% or higher stake in a company must come public under Section 13(d). However, Bebchuk, Brav, Jackson, and Jiang (2013) found that approximately 10% of these filings are made after the required ten-day window. To eliminate this deception while still allowing investors to take a sizeable stake, Strine (2017) suggests increasing the 13D filing stake to “a higher threshold ... and requiring immediate reporting upon hitting that threshold or a requirement to cease further acquisitions until disclosure is made” (p. 1961). By eliminating the “creeping” factor which allows activists to tip off other hedge funds and to “selectively share knowledge of their purchases and other plans with industry colleagues while keeping the larger community of investors in the dark” (Strine, 2017, p. 1962), target companies may better protect themselves and their stakeholders. If a requirement for immediate reporting were instituted, the effect of the “wolf pack” would be reduced, since activists would have less time to alert each other about their strategy. Coffee and Palia (2015) have also suggested the benefit of a “window-closing” poison pill, which management would enact to weaken the investor’s stake if the acquirer did not submit a 13D filing before obtaining a stake of 5% or higher. By requiring immediate disclosure or enacting a poison pill during the 10-day window, the target company would be afforded sufficient time to prepare for activist intervention.

A novel governance practice gaining momentum within the United States is the benefit corporation model, which obliges the board of directors to consider all stakeholders when making decisions about the company’s future. Public benefit corporations are required to “be managed in a manner that balances the stockholders’ pecuniary interest, the best interests of those materially affected by the corporation’s conduct, and the public benefit” (Strine, 2014, p. 243). While non-benefit corporations are solely responsible to the shareholders of the company, benefit corporations are required to take into consideration other constituencies, even if their actions do not completely maximize stockholder value. For example, Strine (2014) points out that in situations involving the forced sale of a company, management would be required to “prefer a responsible bidder ... who has a track record of and is willing to make a binding commitment to managing in a manner that is fair to the corporation’s other constituencies and society” (p. 246), even if another bidder with a poor track record offers a higher price. Many states have adopted statutes pertaining to these organizations, including measures to hold management accountable for their decisions and to allow them the time to enact these strategies. The goal of benefit corporations is to reduce the impact of short-termism which “prevents public companies from operating optimally even for stockholders, as managers cannot chart a sound long-term course without disruption from powerful short-term

interests who can displace them” (Strine, 2014, p. 252). Benefit corporations provide a refreshing opportunity for public companies to utilize a time horizon representative of the interests of all their stakeholders when making strategic decisions that impact their future viability and success.

While activism often harms the majority of long-term human investors, some activist strategies may be beneficial to their targets. In certain instances where company board members were overly dependent on management or unwilling to take the necessary action to strengthen growth, activist involvement resulted in positive change. Intervention by activists has also been useful in cases of management entrenchment, where company leadership has taken advantage of its power and influence at the expense of its stakeholders. Whereas a company connection is often a positive attribute for board members, the advocacy by activists for independent board members can sometimes reinvigorate the board perspective. Although these new members, often hand-selected by the activist, seldom remain on the board for lengthy periods, they may further company goals by their innovative ideas. Activists also champion a more disciplined approach to resource utilization, as well as candidness and communication with stakeholders. For example, the insurance company AIG stated that activists “have forced the company to change the way they report their financials, resulting in more clarity” (Semuels, 2016). At times when a public company is struggling, activism may supply valuable assistance if proffered with a long-term and value-creation viewpoint in mind.

Increasing evidence suggests that hedge funds who hold their investment for five- to ten-years are more likely to be successful and to consider the interests of non-shareholders (Strine, 2017, p. 1892). These hedge funds outperformed the majority of interventions in stock price growth, along with “growth in metrics like research and development spending, sales, and return on assets” (Strine, 2017, p. 1905). By accepting the long-term responsibility and commitment to revitalizing a struggling company, these activists align themselves with the time horizon needed by the human investors to deliver sustainable results for all parties.

However, instances of five- to ten-year investments by hedge funds are rare, with most hedge funds holding their stake for less than two years. Activists often assert that they are invested in the long-term success of their target and have innovative strategies which unlock shareholder value and improve company performance. The most frequent claim by activists that they can deliver a higher return on assets is generally a wealth transfer from other stakeholders to stockholders. Strine (2017) remarks that few, if any, examples exist of hedge funds identifying “an innovative new way to make something ... that humans need or even want ... [and activist

interventions] typically do not involve transformational approaches in managing business, or in marshaling the productivity of American workers” (p. 1953). According to Strine, examples of activism failures to improve company performance, such as J.C. Penney and Sears, are the general norm. The majority of hedge fund managers have never had experience running “an actual business that makes a product or delivers a service” (Strine, 2017, p. 1953). This observant comment brings into question why millions of Americans trust the operational and tactical decisions of hedge fund managers regarding companies whose products and services they know little about. Non-shareholders, public companies, and institutional investors alike should demand clear examples and metrics from activists before allowing hedge funds to influence long-term strategy.

Over the past several decades, activist investors and hedge funds have frequently undermined the viability of public corporations, leaving the often disastrous aftermath of their actions for voiceless stakeholders to rectify after the hedge funds have exited their position. The current governance system grants almost complete control to parties most in conflict with the Efficient Market Hypothesis, employing strategies and financial engineering that undermine their target’s future vitality, as well as the stakeholders who depend on the company’s success. The ability of hedge funds to generate higher returns for their shareholders materializes at the expense of “ordinary Americans [who] are stuck in the market for years and depend on its long-term, sustainable growth for jobs and portfolio gain” (Strine, 2017, p. 1873). Many of the proposed governance changes negatively affect employees in the future financial security of their retirement savings and “their working careers, [since] economic slowdowns that result in job losses and wage stagnation threaten their most important source of wealth” (Strine, 2017, p. 1879).

Human stakeholders rely on public companies to champion effective long-term growth, job creation, and measures that support their ability to save for mortgages, the education of children, and retirement. The ordinary American can prosper only “if public corporations make money the old-fashioned way, by implementing sustainable strategies to sell products and services and not through edgy practices, accounting gimmickry, or never-ending cycles of spin-offs and mergers” (Strine, 2017, p. 1874). The oft-repeated tactic of selling a target earns activists a sizeable premium as they exit their position, but employees, debt-holders, and communities watch many years of hard work and painstaking investment in the company’s long-term success swiftly evaporate. Citing the need to consider a broader sweep of factors, PepsiCo’s former CEO Indra Nooyi argues that a company’s “success is inextricably linked to society’s success ... [and that] if

our financial success comes at the expense of the environment, our consumers or our communities, we will not be viable in the long run” (PepsiCo, 2013, p. 9).

Human investors focus on securing their financial future through the steady and reliable investment techniques of money managers to whom they entrust their money. The individual investor cannot afford the hollowing out of the economy for the sake of short-termism and unrealistic earnings expectations which are frequently based on macroeconomic conditions beyond company control. The current financial climate would be vastly changed if hedge funds, institutional investors, and others with “the power over the capital – equity, debt, and most important, labor – of ordinary Americans were duty-bound to align their thoughts and actions with those they supposedly represent” (Strine, 2017, p. 1970).

The reality of our current governance system reflects the callousness of these short-term investors, who excuse or even applaud their actions as being “a force for good” and “the saviours of public companies” (Allaire, 2015a). The discussion surrounding hedge fund activism has taken on a “surprisingly bloodless quality – one that uses abstraction and distancing to obscure what may be really at stake ... the flesh-and-blood human beings our corporate governance system is supposed to serve” (Strine, 2017, p. 1871). Absent from the pages of endless statistics, quarterly earnings, and proxy votes is the average American worker, who has become a casualty to the ravaging of public companies by corporate raiders searching for quick profit. Society deserves better than the financial reality of the past decade. Institutional investors and public companies need to look at each decision they make from the lens of corporate social responsibility perspective and defend the silent human investor and stakeholders that rely on their ability to stand up to activist investors and hedge funds.

Conclusion

The enlightened stakeholder theory and the shareholder value maximization theory differ from each other in the constituencies prioritized and the timeframe utilized for increasing firm value. While shareholder value maximization tends to focus on how stockholder interests can be advanced in the short term, the enlightened stakeholder theory considers the needs of the many groups dependent on the company’s success while making decisions regarding long-term value. The important presence of a diverse group of stakeholders within the latter theory corresponds well with the goals of corporate social responsibility, where corporations are challenged to exercise their resources for the good of society. While stockholder value maximization evinces a lucid

objective to magnify the short-term wealth of stockholders, it does not address the broad needs of all the stakeholders involved or establish sustainable and lasting financial strategies.

Corporate social responsibility is often viewed as a simple buzzword to be checked and many times is manipulated to ensure that the sponsoring firm gains significantly, both financially and in repute. However, the authentic definition of corporate social responsibility challenges leadership to value the communities, environment, culture, and stakeholders that surround the company, without thought of personal or short-term gain. Public firms and corporations should work to enact and foster measures that address the needs of all corporate constituencies in the search for long-term value. In particular, companies can analyze long-term value metrics as a means of measuring company and managerial success, while also emphasizing consistent innovation and careful strategy to improve performance. Businesses should also call upon their investors to commit to the sustained progress and stability of the firm and to collaborate with managers in a manner which upholds the timeline of those individuals whose capital they represent. Similarly, policymakers should utilize their power to further legislation that increases enhanced voting rights and rewards those entities which are committed to a firm's long-term success. In addition, laws should be considered that grant sufficient time to targeted companies to defend against a hostile takeover, while at the same time retaining opportunities for mergers and acquisitions. Lawmakers can also work to lessen the role of proxy firms in the investing decisions of institutional investors and instead empower these large entities to accept ownership of the long-term interests of their clients. Through these defined actions, society can ensure that the long-term value of public corporations remains secure and that all stakeholders have a fair system under which to operate.

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