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CORPORATE GOVERNANCE AND THE NEW HEDGE FUND ACTIVISM: AN EMPIRICAL ANALYSIS

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Hedge funds are not “normal” institutional investors. They launch proxy fights for corporate control. Their recent successes and “wolf pack” tactics have garnered headlines, but leave us with a question: what does hedge fund activism mean for corporate governance in the United States? This Article undertakes a legal, empirical, and theoretical study in an effort to answer this question. The heart of the Article is an empirical study of obtainable instances of hedge fund activism during 2005 and the 2006 proxy season. The Article starts by showing that the SEC opened the door to hedge fund activism when it stopped censoring most proxy material in 1992 and started allowing proxy “free communication” in 2000. The Article’s empirical survey found nearly 50 instances of hedge fund activism, and also found the in terrorem effect of these examples to be considerable. The survey further found that the combination of “wolf pack” tactics and the increasing influence of activist proxy advisory firms (the recommendations of which many institutional investors follow automatically) have made hedge fund activists a real power in corporate governance. Despite some claims that hedge funds often hold short positions or are otherwise dangerously conflicted, the survey only found very limited evidence for this; the survey also found that hedge funds have, in fact, disclosed these conflicts, though the proxy and Williams Act rules in this respect should be clarified. The Article then subjects these results to theoretical analysis using current nexus of contracts, shareholder primacy, director primacy, team production, connected contracts and other theories and finds none completely satisfactory. The Article concludes that an almost unprincipled balance-of-power political model best explains the hedge fund activism phenomenon. In the end, if these activities cause managements to review and reassess their strategies, corporate governance is improved.

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INTRODUCTION

After an absence of over a decade, shareholder activism is once again a hot topic,¹ but this time with a difference. Back in the early 1990s, the focus was on institutional investors and whether they could step in and help keep corporate managements in line after hostile takeovers had fizzled a few years earlier.² Now “hungry” hedge funds with outsized war chests and egos to match are said to be the “new raiders,” or even the “new sheriffs of the boardroom.”³ While hedge funds openly posture and threaten, lawyers

¹ See, e.g., K.A.D. Camara, *Classifying Institutional Investors*, 30 J. CORP. L. 219, 222 & n.11 (2005) (commenting that “[i]nstitutional investors were last a hot topic in the late 1980s and early 1990[s]” and providing a brief literature summary). The author’s views on early 1990s shareholder activism are set forth in Thomas W. Briggs, *Shareholder Activism and Insurgency Under the New Proxy Rules*, 50 BUS. LAW. 99 (1994).

² A representative article on this topic is perhaps Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990) (better institutional monitoring would likely happen if legal restrictions on shareholders were loosened). But by the late 1990s, Professor Black had acknowledged that his hopes for the role that institutional monitoring could play in corporate governance were all but dashed. See Bernard S. Black, *Institutional Activism and Corporate Governance in the United States*, in 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 459 (Peter Newman ed. 1998) (low institutional activism efforts produce commensurately low results).

³ See Mara Der Hovanesian, *Attack of the Hungry Hedge Funds*, BUS. WK., Feb. 20, 2006, at 72; Allan Murray, *Hedge Funds Are the New Sheriffs of the Boardroom*, WALL ST. J., Dec. 14, 2005, at A2; Emily Thornton, *The New Raiders*, BUS. WK., Feb. 28, 2005, at 32. See also Andrew Ross Sorkin, *To Battle, Armed with Shares*, N.Y. TIMES, Jan. 4, 2006, at C1 (“[T]oday corporate boards are adjusting to a new reality: the activist investor, armed with a handful of shares and a megaphone, is changing corporate America and the deal-making landscape”).

and consultants for corporations send their clients memoranda with titles like *The New Crisis* and (in plainer English) *Be Prepared For Attacks by Hedge Funds*.⁴ Some even believe that managements and these new activist shareholders are battling for corporate America.⁵

This battle is occurring now for three principal reasons. First, in the past few years, hedge funds have attracted an enormous amount of capital at the same time that returns in their traditional, lower-profile strategies have stagnated.⁶ Hedge funds now invest well over a trillion dollars,⁷ and all that money has to go somewhere. Their investors, moreover, generally expect market-beating or even absolute returns in exchange for the hefty fees most hedge funds charge.⁸ The pressure to perform is on. And yet hedge fund

⁴ Compare Justin Hibbard, *Take Your Best Shot, Punk*, BUS. WK., Nov. 7, 2005, at 118 (quoting hedge fund manager as saying, “We’re putting together a war machine . . . [and] no company will be safe”), with Martin Lipton *et al.*, Memorandum to Clients, *Be Prepared For Attacks By Hedge Funds* (Dec. 21, 2005) (“Expose the attackers for what they are, self-seeking, short-term speculators looking for a quick profit at the expense of the company and its long-term value.”), available at <http://www.realcorporatelawyer.com/pdfs/wlrk122205-02.pdf>. See also Bryan Armstrong, *The New Crisis: Shareholder Activism* (2005), <http://www.ashtonpartners.com/default.aspx?pageID=79>; David A. Katz & Laura A. McIntosh, *Advice on Coping with Hedge Fund Activism*, N.Y.L.J., May 25, 2006, at 5.

⁵ See *Battling for Corporate America*, ECONOMIST, Mar. 11-17, 2006, at 69 (asking, “Who will come out on top in the renewed struggle between shareholders and managers?”).

⁶ See, e.g., William Fung, David A. Hsieh, Narayan Y. Naik & Tarun Ramadorai, *Hedge Funds: Performance, Risk and Capital Formation*, at 2 (SSRN Working Papers, Feb. 11, 2006), <http://ssrn.com/abstract=778124> (providing evidence that “even successful funds have experienced a recent, dramatic decline in risk-adjusted performance”); Erin E. Arvedlund, *Easing the Sting*, BARRON’S, Jan. 30, 2006, at 46 (Burton Malkiel noting that hedge fund performance appears to have entered “an era of single-digit returns”); Susan Pulliam & Martin Peers, *Once a Lone Wolf, Icahn Goes the Hedge-Fund Route*, WALL ST. J., Aug. 12, 2005, at A1 (“The quick profits that hedge funds seek are harder to come by now, partly because they’ve exploded in number, resulting in far more savvy investors on the prowl and thus fewer undiscovered values.”); Henry Sender, *Hedge Funds: The New Corporate Activists*, WALL ST. J., May 13, 2005, at C1 (noting that traditional passive strategies no longer work so “instead of just taking bets on the outcome of others’ moves, [hedge funds] themselves are becoming the catalyst for change in the corporate world.”); *Thorns in the Foliage*, ECONOMIST, Apr. 1-7, 2006, at 61 (noting that “these days it is becoming harder for hedge-fund managers to make money”).

⁷ See Lauren Etter, *Volatile Markets Bring Hedge Funds Under Fire*, WALL ST. J., July 1-2, 2006, at A9; *Hedge Funds: Growing Pains*, ECONOMIST, Mar. 4-10, 2006, at 63.

⁸ See Steve Fishman, *Get Richest Quickest*, N.Y. MAG., Nov. 22, 2004, at 28 (article subtitled “In the precarious hedge-fund bubble, it’s either clean up – or flame out.”). Hedge fund fees vary considerably, but often consist of a management fee of up to 2% per year plus a performance fee of 20% or more of profits; mutual fund fees are often 1% with no performance fee. See *id.*; see also Jenny Anderson, *For Hedge Funds, Life Just Got a Bit More Complicated*, N.Y. TIMES, Mar. 31, 2006, at C8 (mutual fund fees average 1.4%); *Growing Pains*, *supra* note 7, at 64; John Waggoner, *Managed Funds Top S&P 500 Index Again*, USA TODAY, Jan. 4, 2006, at D1.

industry returns were hardly better than flat in 2004 and amounted to not much more than a market index return in 2005.⁹ According to one knowledgeable observer, some funds are consequently “turning to activism because it is getting tougher to show top-notch returns as more hedge funds pursue similar investment ideas and overall market volatility drops.”¹⁰ Second, in our post-Enron, post-Sarbanes-Oxley world, there may be a greater willingness on the part of investors to hold underperforming managements to account.¹¹ And third, as this Article will show, recent legal reforms and court decisions have largely deregulated proxy contests and other shareholder insurgency activities so as to make hedge fund attacks easier and cheaper.¹²

Meanwhile, another more complicated battle is taking place, this time among academic commentators and the corporate community. The issue is the role shareholders (including hedge funds) play in corporate governance. Lined up on one side are those who believe that shareholders actually own corporations and should have a greater say in how they are run.¹³

⁹ See *Growing Pains*, *supra* note 7; see also Jenny Anderson, *Atop Hedge Funds, Richest of the Rich Get Even More So*, N.Y. TIMES, May 26, 2006, at C1, 22 (citing “less than stellar” recent hedge fund performance and noting John Bogle’s acid comment that “[y]ou would think someone would be a little embarrassed taking all that money for humdrum returns”). Of course hedge fund returns are self-reported and leave some wondering about the accuracy of published results. See Floyd Norris, *Are These Hedge Fund Results Real?*, N.Y. TIMES, Apr. 21, 2006, at C1 (summarizing recent research).

¹⁰ Gregory Zuckerman, *Big Shareholders Are Shouting Ever Louder*, WALL. ST. J., Nov. 23, 2005, at C1.

¹¹ See Riva Atlas, *Some Funds Taking Role Far Beyond Just Investor*, N.Y. TIMES, Aug. 16, 2006, at C1 (view that “[i]n the wake of corporate scandals and passage of the Sarbanes-Oxley Act, it is harder for companies to ignore shareholders’ views”); Charles M. Nathan & Erik A. Lopez Sr., *Hedge Funds and M&A – New Sharks and Too Little Shark Repellant*, in 2 37TH ANNUAL INSTITUTE ON SECURITIES REGULATION 11, 44 (PLI Corp. L. & Prac. Handbook Ser. No. 1517, 2005) (“In this post-scandal decade, the overall mood is oriented toward rooting out corporate misdeeds, an aim which activist hedge funds frequently purport to be seeking.”); Pulliam & Peers, *supra* note 6 (Carl Icahn’s view that “there has been a sea change in investor attitudes concerning the role of entrenched corporate managements” and that shareholders now “want to hold them accountable.”). Thornton, *supra* note 3, at 32 (“In the wake of Enron and other scandals, companies have never been as vulnerable to shareholder demands as now.”).

¹² See *infra* Part I.

¹³ See, e.g., Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784 (2006); Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005); Lucian A. Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43 (2003). See also Melvin A. Eisenberg, *The Conception That the Corporation Is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819, 832 (1999) (noting that “[m]ost (although by no means all) corporate scholars subscribe to the norm of shareholder primacy, under which the objective of the corporation’s management should be to increase shareholder wealth”).

Shareholders, according to this view, should have direct input in selecting director candidates and even in making other major corporate decisions when directors are not up for election. Against them stand those who distrust shareholders (perhaps especially including hedge funds) and believe that companies are best run by directors who supervise professional managers.¹⁴ Many in the corporate community stand somewhere in the middle of all this, and appear largely to favor the status quo.¹⁵ Their argument points to the *modus vivendi* constructed by the Delaware courts a generation ago in *Unocal Corp. v. Mesa Petroleum Co.*¹⁶ and its progeny and basically amounts to if-it-isn't-broken-don't-fix-it. In any event, the fundamental question seems to be whether hedge fund activism will accomplish little but generate headlines and disappear like the hostile takeover boom of the 1980s or whether hedge funds can positively influence corporate managements and thereby play a real, lasting and useful role in American corporate governance.¹⁷

This Article contributes to this debate by examining in detail how hedge fund activism actually happens and whether it betters corporate governance. Part I reviews the recent legal history of shareholder activism and examines why this past year, according to one leading proxy solicitation firm, “marked the emergence of hedge funds as a force to be reckoned with in election contests and mergers.”¹⁸ Part II presents a comprehensive empirical survey of what hedge funds are, in fact, doing and examines how they are doing it. Have the new hedge fund barbarians sacked corporate

¹⁴ See, e.g., Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U.L. REV. 547 (2003); Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561 (2006).

¹⁵ Martin Lipton & Steven A. Rosenblum, *Election Contests In the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67 (2003); Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759 (2006); A. Gilchrist Sparks, III, *Corporate Democracy: What It Is, What It Isn't, and What It Should Be*, INSIGHTS, Mar. 2006, at 20.

¹⁶ 493 A.2d 946 (Del. 1985) (imposing a higher, “reasonable in relation to the threat posed” standard of judicial scrutiny in cases reviewing director conduct in takeover situations).

¹⁷ See *Hedge Fund Activism* (May 27, 2005), ProfessorBainbridge.com, http://www.professorbainbridge.com/2005/05/hedge_fund_acti.html (“Are hedge funds the next big thing in corporate governance, solving the principal-agent problems inherent in that governance structure . . . [o]r will they fizzle out the way hostile takeovers and, to a lesser extent, institutional investor activism have?”).

¹⁸ Georgeson Shareholder, *Annual Corporate Governance Review 4* (2005), available at www.georgesonshareholder.com/pdf/2005_corpgov_review.pdf.

Rome or are they merely diligent and useful tillers of the corporate governance soil? Part III explores the implications of the findings presented in Part II, analyzes whether hedge funds are a problem that needs to be fixed, and presents a modest proposal for regulatory reform. Part IV then shows how hedge funds do not fit into present-day corporate governance theories and develops a new theory based on a balance-of-power analysis. The Article concludes, as some argued a decade ago in the early days of investor activism, that politics has indeed come to the world of corporate governance¹⁹ and that hedge fund activists are having a far greater impact than their absolute numbers might suggest.

I. THE LEGAL FOUNDATIONS OF HEDGE FUND ACTIVISM TODAY

To begin with, there is no legal or even generally accepted definition of a “hedge fund.” According to the Securities and Exchange Commission, a hedge fund is any privately offered “entity that holds a pool of securities” or other assets and that is not a registered mutual fund.²⁰ Perhaps many people simply think of hedge funds as secretive, aggressive, anything-goes investors.²¹ For purposes of this Article, the term includes plain vanilla hedge funds as well as other, “fellow traveling” funds with a similarly aggressive activist investment style. But for any investor, SEC and related rules form a veritable slalom course that must be run in any proxy fight or other shareholder activism effort. These rules have essentially been reworked twice in recent years, first in 1992 with the avowed purpose of making traditional large-institution activism easier, and then again near the turn of the millennium to streamline merger and acquisition transactions. As the following pages will describe, however, the surprising consequences of these changes for hedge fund activism have only recently become fully apparent. Two of the changes, the termination of SEC proxy censorship and the free-communication rule adopted in 1999, have essentially revolutionized proxy fights and made hedge fund activism as we know it

¹⁹ See, e.g., John Pound, *The Rise of the Political Model of Corporate Governance and Corporate Control*, 68 N.Y.U. L. REV. 1003 (1994); John Pound, *Beyond Takeovers: Politics Comes to Corporate Control*, HARV. BUS. REV., Mar.-Apr. 1992, at 83. For a cogent rebuttal, see Thomas A. Smith, *Institutions and Entrepreneurs in American Corporate Finance*, 85 CAL. L. REV. 1 (1997).

²⁰ See SEC Staff Report, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 3 (2003), available at <http://www.sec.gov/divisions/investment.shtml>; see also *Goldstein v. SEC*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 93,890, at 90,608 (D.C. Cir. June 23, 2006) (“‘Hedge funds’ are notoriously difficult to define.”); *What’s in a Name?*, ECONOMIST, Mar. 4-10, 2006, at 64 (“The label ‘hedge fund’ is getting fuzzier by the day”).

²¹ See, e.g., Amey Stone, *Hedge Funds Are Everyone’s Problem*, BUS. WK. ONLINE, Aug. 6, 2004, http://www.businessweek.com/bwdaily/dnflash/aug2004/nf2004086_0880_db042.htm (calling hedge funds “souped-up speculative trading vehicles”).

today possible.

A. The SEC Rules and the 1992 Reforms

Absent an available exemption, any shareholder “solicitation” automatically invokes the full panoply of the SEC’s proxy rules.²² These rules define a “solicitation” as any communication to shareholders “under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy.”²³ This is a facts-and-circumstances test. Even the SEC has acknowledged that what constitutes a solicitation is therefore “not always clear,” and that “almost any statement of views” could expose a shareholder to litigation risk.²⁴ Cautious lawyers consequently advise their clients accordingly.

Complying with the rules means filing a proxy statement and card in preliminary form with the SEC for review by the staff.²⁵ Once all comments are cleared, the shareholder is free to mail its materials to all or as many other shareholders as it wishes.²⁶ Identifying these other shareholders and coping with the truly Byzantine complexity of actually reaching them through brokerage firm and other Wall Street back offices²⁷ in turn necessitates hiring a financial printer and a professional proxy solicitation

²² See 17 C.F.R. § 240.14a-3(a) (2006); Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,051 (Oct. 16, 1992) (adopting the 1992 reforms).

²³ 17 C.F.R. § 240.14a-1(l) (2006). See Exchange Act Release No. 5276, [1952-1956 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,380 (Jan. 17, 1956) (original adopting release for the current proxy rules) (explaining that “statements made for the purpose of inducing security holders to give, revoke, or withhold a proxy . . . by any person who has solicited or intends to solicit proxies . . . may involve a solicitation within the meaning of the regulation, depending upon the facts and circumstances”). Much has been written on “solicitation.” See, e.g., RANDALL S. THOMAS & CATHERINE T. DIXON, ARANOW & EINHORN ON PROXY CONTESTS FOR CORPORATE CONTROL § 5.02 (3d ed. 1998); Briggs, *supra* note 1, at 103-110 (collecting authorities).

²⁴ Release No. 31,326, *supra* note 22, at 83,358; Exchange Act Release No. 30,849, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,002, at 83,358 (June 24, 1992).

²⁵ 17 C.F.R. §§ 240.14a-3(a) & -6 (2006).

²⁶ Unlike companies, which have to mail to everyone, shareholders can generally mail to as many shareholders as seems tactically expedient. See Release No. 31,326, *supra* note 22, at Part II.D.

²⁷ In the context of proxy voting, these complexities have only recently begun to attract serious study and attention. See Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 SO. CAL. L. REV. 811 (2006); Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775.

firm, which only adds to the legal expenses already incurred.²⁸ But from here things get easier. After distributing the proxy statement, nothing else that an insurgent sends out has to be precleared with the SEC, as had been the case before the 1992 reforms.²⁹ According to the adopting release, the SEC got itself out of the proxy censorship business because it believed that contestants “should be free to reply to [an opponent’s] statement in a timely and cost-effective manner, challenging the basis for the claims and countering with their own views on the subject matter through the dissemination of additional soliciting material.”³⁰ This change has proved to be revolutionary. Restrained only by the general proxy antifraud rule,³¹ a hedge fund activist is now free to disseminate to the world near telephone books full of essentially unverifiable presentation slides.

There are two genuinely useful exemptions from these rules, the ten-or-fewer rule³² and the free-speech rule adopted as part of the 1992 reforms.³³ The ten-or-fewer rule allows a contestant to solicit freely up to ten other shareholders without filing anything with the SEC, and can be extremely valuable in the early stages of getting an insurgency campaign off the ground. In situations where ownership is fairly concentrated, this first effort can sometimes even prove determinative.³⁴ The free-speech rule allows an insurgent to solicit an unlimited number of holders without filing anything with the SEC except a copy of any written materials.³⁵ The insurgent must use management’s proxy card and generally cannot have an intent to engage in a proxy solicitation for the election of directors or any other “control

²⁸ See Constance E. Bagley & David J. Berger, PROXY CONTESTS AND CORPORATE CONTROL, at A-5 to A-11, B-101 (2001) (BNA Corp. Prac. Ser. No. 70).

²⁹ 17 C.F.R. § 240.14a-6(a) & (b) (2006).

³⁰ Release No. 31,326, *supra* note 22, at 83,365.

³¹ 17 C.F.R. § 240.14a-9 (2006).

³² 17 C.F.R. § 240.14a-2(b)(2) (2006).

³³ 17 C.F.R. § 240.14a-2(b)(1) (2006); Release No. 31,326, *supra* note 22. Until 2000, another useful exemption permitted limited early communications in contests. See Regulation of Takeovers and Security Holder Communications, Securities Act Release No. 7760, 64 Fed. Reg. 61,408 (Nov. 10, 1999) (rescinding former Rule 14-11(b)); Briggs, *supra* note 1, at 141-42.

³⁴ On one recent occasion an insurgent was able to win a contested vote on a ten-or-fewer basis alone. See American Building Control, Inc., Schedule 13D (June 21, 2004); Current Report (Form 8-K) (June 22, 2004) (filings reflecting replacement of company chairman in contested election). The author represented the shareholder in this situation. See also *Crouch v. Prior*, 905 F. Supp. 248 (D.V.I. 1995) (preliminary injunction granted for soliciting over ten shareholders); Briggs, *supra* note 1, at 102-10 (detailed analysis).

³⁵ 17 C.F.R. § 240.14a-103 (2006) (form of “Notice of Exempt Solicitation”).

transaction.”³⁶ Nevertheless, the rule enables an insurgent to run an inexpensive campaign for or against any management or shareholder proposal appearing on management’s proxy card.³⁷ Hedge fund activists principally use the rule to attack unwanted mergers.

The remaining useful proxy reform is the “short slate” rule.³⁸ Although rarely used, the rule permits a dissident to run a slate of fewer directors than there are seats up for election.³⁹ A shareholder simply sends out a proxy card naming its own nominees plus those management nominees for whom it will *not* vote, thereby casting a vote for all available seats.⁴⁰ The strategic thought here is that running a short slate permits a less confrontational, constructive engagement with management while at the same time seeming less risky and therefore more attractive to an institutional voting base.

Apart from the proxy rules, the other regulatory hurdle facing a would-be insurgent is the SEC’s Schedule 13D and its accompanying rules.⁴¹ The two main issues are the “group” issue and the “intent” issue. Corporate defense lawyers will first look here for litigation fodder.⁴²

These rules require the filing of an ownership report on Schedule 13D within ten days after the acquisition of five percent or more of a company’s stock.⁴³ Any two or more persons will be considered one aggregated filing group if they have agreed to act together “for the purpose of acquiring,

³⁶ 17 C.F.R. § 240.14a-2(b)(2) (2006); Release No. 31,326, *supra* note 22, at 83,360-62. The insurgent, moreover, must use management’s actual proxy cards, not reprints. *See* *MONEY Group, Inc. v. Highfields Capital Mgmt., L.P.*, 368 F.3d 138 (2d Cir. 2004) (SEC staff disagreement with this result).

³⁷ *See* Release No. 3126, *supra* note 22, at 83,358 & 83,364-65.

³⁸ 17 C.F.R. § 240.14a-4(d) (2006).

³⁹ *See* Meredith M. Brown *et al.*, TAKEOVERS: A STRATEGIC GUIDE TO MERGERS AND ACQUISITIONS, at 6-142 to -44 (2d ed. 2004) (brief review); Charles I. Cogut, William E. Curbow & Patrick E. King, *Short Slates*, 28 REV. SEC. & COMM. REG. 79 (1995) (comprehensive analysis).

⁴⁰ *See* Ronald J. Gilson, Lilli A. Gordon & John Pound, *How the Proxy Rules Discourage Constructive Engagement: Regulatory Barriers to Electing a Minority of Directors*, 17 J. CORP. L. 29 (1991) (article that led to adoption of short slate rule).

⁴¹ *See* Regulation 13D, 17 C.F.R. § 240.13d-1 to -7 (2006); Schedule 13D, 17 C.F.R. § 240.13d-101 (2006). These rules and the cases applying them are comprehensively analyzed in Briggs, *supra* note 1, at 111-26.

⁴² *See* 1 Arthur Fleischer, Jr. & Alexander R. Sussman, TAKEOVER DEFENSE § 11.02 (6th ed. 2004) (subsection entitled “Suing an Accumulator”); *Be Prepared for Attacks By Hedge Funds*, *supra* note 4 (advising clients to be prepared to litigate group and intent issues).

⁴³ The filing rules are succinctly summarized in Thomas R. Stephens, BENEFICIAL OWNERSHIP REPORTING: SCHEDULES 13D AND G (2003) (BNA Corp. Prac. Ser. No. 68).

holding, voting or disposing” of the shares.⁴⁴ And “holding” or “voting” most assuredly include the concept of threatening to vote.⁴⁵ The agreement in any event need not be in writing, may be informal and may be inferred from circumstantial evidence. The real-world problem most frequently encountered here is determining when discussions among shareholders about influencing company strategy or the make-up of management ripen into a disclosable agreement to form a group. The cases are legion, and generally leave even the most knowledgeable lawyers wondering where exactly to draw the line for their clients.⁴⁶

Still more cases concern the “intent” issue. Schedule 13D calls for the disclosure of any “plans or proposals” concerning an entire laundry list of corporate events, including mergers or other extraordinary corporate transactions, changes in the board of directors or management, asset sales or anything else similar to the enumerated items.⁴⁷ Any material change in these plans then requires the “prompt” filing of an updating amendment to the Schedule.⁴⁸ Again, the real-world problem most frequently encountered is determining when brain storms, mere suggestions and other preliminary ideas ripen into disclosable plans or proposals. The cases here, too, are legion.⁴⁹ Perhaps the safest conclusions are that a shareholder must absolutely disclose all definitive plans and that any undisclosed plans had better not show up in the garb of outwardly seeming definitiveness when discovery occurs and depositions are taken.

B. The Turn-of-the-Millennium Changes

Although these proxy and Schedule 13D rules remain with us today, several important changes over the past few years have operated to blunt their regulatory impact and help fuel the recent surge of hedge fund activism. Judicial decisions have also contributed to these developments as the courts have continued to work through applying precedents largely

⁴⁴ 17 C.F.R. § 240.13d-5(b) (2006).

⁴⁵ See Briggs, *supra* note 1, at 112-17.

⁴⁶ See *id.* (comprehensive analysis); *infra* at text accompanying notes 59-66 (update).

⁴⁷ See Schedule 13D, Item 4, 17 C.F.R. § 240.13d-101, Item 4 (2006); Briggs, *supra* note 1, at 121-26; Albert J. Li, *The Meaning of Item Four of Schedule 13D of the Securities Exchange Act of 1934: A New Framework and Analysis*, 52 BUS. LAW. 851 (1997).

⁴⁸ 17 C.F.R. § 240.13d-2(a) (2006).

⁴⁹ See Briggs, *supra* note 1, at 121-26 (comprehensive analysis); see also *Azurite Corp. v. Amster & Co.*, 52 F.3d 15 (2d Cir. 1995) (confirming that mere preliminary plans do not require disclosure); *Independent Fed. Sav. Bank v. Bender*, 332 F. Supp. 2d 203 (D.D.C. 2004) (same).

developed during the take-over boom of the late 1970s and 1980s to the more ordinary rough-and-tumble of shareholder activism.

By far the most important change, really a revolutionary change, was the addition in late 1999 of a new Rule 14a-12 to the proxy rules as part of the promulgation of Regulation MA for take-over transactions.⁵⁰ So long as no proxy card is furnished, Rule 14a-12 effectively allows unlimited solicitations before any proxy statement is filed. Written materials must be filed with the SEC upon their first use, must disclose all the participants in the proxy solicitation and their shareholdings, and must contain prescribed legends. Oral communications, according to the adopting release, are also freely permitted and “do not need to be reduced to writing and filed.”⁵¹ Of course, a participant must truly intend to prepare and disseminate a proxy statement.⁵² But if the solicitation is abandoned, there never will be any proxy statement.⁵³ (Cynics might detect a wink here.) It also goes without saying that a proxy participant can send all this information out to shareholders and the press.⁵⁴ By the time an actual proxy statement is finally ready to mail, more than a few fights will already be practically over or settled entirely.⁵⁵

A proposed modernization of the proxy statement delivery rules should in any event make it much easier and cheaper to follow through to a finish any proxy fight that does not settle, and may prove equally revolutionary.⁵⁶

⁵⁰ See 17 C.F.R. § 240.14a-12 (2006); Release 7760, *supra* note 33 (adopting release). See also Regulation of Takeovers and Security Holder Communications, Securities Act Release No. 7607, 67 Fed. Reg. 67,331 (Dec. 4, 1998) (proposing release).

⁵¹ See Release 7760, *supra* note 33, at 61,414.

⁵² See SEC Division of Corporation Finance: Manual of Publicly Available Telephone Interpretations, at Part I.D, Question No. 3, <http://www.sec.gov/interps/telephone/phone/supplement3.htm> (3d Supp. July 2001) (“In order to rely on Rule 14a-12, soliciting parties must intend to furnish a proxy statement to security holders.”).

⁵³ See Release 7760, *supra* note 33, at 61,415 (“[P]arties relying on the rule are not obligated to furnish a written proxy statement if the solicitation is discontinued for any reason.”).

⁵⁴ Release 7607, *supra* note 50, at 67,340. See also Eugene F. Cowell III, *Internet Technology Permits New Proxy Contest Techniques*, INSIGHTS, Oct. 2001, at 17 (summarizing internet distribution techniques under Rule 14a-12).

⁵⁵ See *Georgeson Shareholder*, *supra* note 18, at 4 (noting decline in all-out proxy fights “as management frequently decided to reach settlements with their dissident shareholders rather than risk a full-scale battle”).

⁵⁶ See Internet Availability of Proxy Materials, Exchange Act Release No. 52,926, 70 Fed. Reg. 74,598 (Dec. 15, 2005) (proposing release); Ron Orol, *SEC Readies New Proxy Statement Rules*, N.Y.L.J., Mar. 9, 2006, at 5 (noting that the proposal is “expected to be adopted later this year”); see also Dennis O. Garris & Catherine A. Duke, *SEC Proposes the Use of the Internet for Proxy Solicitations*, INSIGHTS, Jan. 2006, at 11, 14 (“[M]ost

After moving the public offering regulatory regime under the Securities Act to an internet-access-equals-delivery model last year,⁵⁷ the SEC is likewise moving the proxy disclosure system to a notice-and-internet-access model. For a dissident shareholder, issuing a press release or simply emailing Rule 14a-12 material would constitute sufficient notice. “Thus,” according to the SEC’s proposing release, a shareholder “could effect a widespread solicitation of proxies without [actually] delivering any [n]otices at all, provided that it does not furnish or provide a means of obtaining a proxy card except on the Web site where its proxy materials are posted.”⁵⁸

The SEC similarly streamlined the Schedule 13D rules in 1998 when it added a new category of ordinary “passive” investors such as hedge funds to those eligible to file an abbreviated disclosure statement on short-form Schedule 13G.⁵⁹ The principal benefits of the form over the longer Schedule 13D are that it generally requires updating only once a year and that it calls for no disclosure at all about an investor’s purpose or intentions; contrariwise, a Schedule 13D has to be amended promptly for any material change and requires detailed purpose and intent disclosure.⁶⁰ The obvious strategic benefit of using the short form Schedule 13G is that it allows for a surprise attack: with no “purpose” disclosure and but once yearly ownership disclosure, who other than the investor itself can really tell what is going on until, as at Pearl Harbor, it is too late? The equally obvious flip side to this question is when exactly does such an investor become non-passive and so have to switch from a Schedule 13G to a Schedule 13D? The SEC noted in its adopting release that such a determination can be “difficult and fact intensive.”⁶¹ As a practical matter, however, it seems that merely making suggestions to management about what it should be doing is perfectly permissible, while seeking board representation, proposing an

importantly, the proposed rules will allow proxy solicitations to be waged by third parties at virtually no cost to the third party.”); David A. Katz & Laura A. McIntosh, *A Seismic Shift in Mechanics of Electing Directors*, N.Y.L.J., July 27, 2006, at 5 (noting that dissident costs would be “significantly diminished”).

⁵⁷ See Securities Offering Reform, Securities Act Release No. 8591, 70 Fed. Reg. 44,722, at Part VI (Aug. 3, 2005).

⁵⁸ Release No. 52,926, *supra* note 56, at 74,608.

⁵⁹ See Amendments to Beneficial Ownership Reporting Requirements, Exchange Act Release No. 39,538, 63 Fed. Reg. 2854 (Jan. 16, 1998). Note that such a passive investor’s ownership level also has to be under 20%. *Id.*

⁶⁰ If, however, an investor’s ownership exceeds 10%, additional Schedule 13G amendments are required for any 5% change. 17 C.F.R. § 240.13d-2(d) (2006). The Schedule 13D amendment rule is at 17 C.F.R. § 240.13d-2(a) (2006) and provides, among other things, that a 1% change in an investor’s ownership level is material and thus requires an amendment.

⁶¹ Release No. 52,926, *supra* note 56, at 2859.

acquisition or otherwise making threats are not.⁶²

The courts have also contributed to streamlining the rules for hedge fund activism. From a tactical point of view, the most important development is their continued reluctance to find undisclosed groups lurking amidst shareholders who merely talk to one another and have frank exchanges of views about their investee companies. In *Hallwood Realty Partners, L.P. v. Gotham Partners, L.P.*, for example, the Second Circuit refused to find that two Schedule 13D filers and a Schedule 13G filer were a group just because one was a known raider, two bought stock during the same period, and all three discussed what to do about their investment.⁶³ Based in part on *Hallwood*, a flurry of emails and even a joint slate of directors were not enough to persuade another court that the investors had formed a group.⁶⁴ “Congress,” said the court, “did not intend for Section 13(d) to serve merely as an eleventh-hour bludgeon for managements embroiled in proxy contests.”⁶⁵ Decisions such as these have enabled hedge funds to engage in “wolf pack” tactics against companies undeterred by a fear of somehow magically becoming a group merely because they hunt together and seek the same prey.⁶⁶

These wolf packs, moreover, can often have an influence far out of proportion to their actual shareholdings because of recent regulatory action mandating responsible fiduciary proxy voting by institutional investors. Another, more succinct name for this phenomenon might be the Rise of

⁶² Compare *Egghead.com, Inc. v. Brookhaven Cap. Mgmt., Inc.*, 194 F. Supp. 232 (S.D.N.Y. 2002) (summary judgment on passivity issue denied because of intense strategic debates and seeking of possible board representation), with *Transcon Lines v. A.G. Becker Inc.*, 470 F. Supp. 356 (S.D.N.Y. 1979) (ruling that mere suggestions and discussions with management about corporate policies do not constitute non-passive control purpose). See Karl A. Groskaufmanis & Janet G. Gamer, *Monitoring the Dance: An Assessment of the SEC's Regulation 13D-G Amendments*, CORP. GOVERNANCE ADVISER, July-Aug. 1998, at 16, 18 (noting that suggesting a divisional spin-off is passive, but that if the same suggestion were presented “as a demand by a substantial shareholder with the implicit (or explicit) threat to rally other substantial shareholders on the same issue, it becomes a different analysis”).

⁶³ 286 F.3d 613 (2d Cir. 2002).

⁶⁴ See *meVC Draper Fisher Jurvetson Fund I, Inc. v. Millennium Partners, L.P.*, 260 F. Supp. 2d 616, 631-33 (S.D.N.Y. 2003).

⁶⁵ *Id.* at 633.

⁶⁶ See *infra* Part II.B.2. From the point of view of a management-side observer, “[t]his form of parallel action, driven by numerous independent decisions by like-minded investors, as opposed to explicit cooperation agreements among participants, has allowed hedge funds to avoid being treated as a ‘group’ for purposes of Regulation 13D.” See Nathan & Lopez, *supra* note 11, at 41. On the other hand, truly egregious flouting of the “group” rule could lead to being on the wrong end of an SEC enforcement action. See John Joslyn, 83 SEC Docket 3127 (Oct. 26, 2004) (willful failure to file in proxy take-over scheme).

Institutional Shareholder Services, or ISS for short. ISS got its start in the late 1980s when the Department of Labor, which supervises pension funds, ruled that “[t]he fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies.”⁶⁷ The SEC then joined the party in early 2003 when it adopted rules mandating that registered investment advisers vote proxies “in the best interest of clients” and that registered mutual funds disclose both their proxy voting policies and how they actually voted.⁶⁸ As a practical matter, cost effective compliance has meant hiring someone else to vote the shares, namely ISS. And ISS has a distinctly activist bent.⁶⁹ The firm’s current voting policies, for example, support only the weakest kinds of poison pills, and only then if shareholders ratify them within a year, and mandate voting against all board members of all companies that deviate from this approach.⁷⁰ More critically, in contested board elections and other corporate disputes, ISS has become increasingly willing to support dissident candidates and positions.⁷¹

ISS and its competitors have, in fact, become enormously influential and have also helped weaken corporate defenses. Although it is difficult to quantify ISS’s precise impact, a recent Business Roundtable survey concluded that an average of 40% of its responding members’ shares were

⁶⁷ 29 C.F.R. § 2509.94-2 (2006) (1994 codification of policies previously issued less formally in advisory letters).

⁶⁸ See Proxy Voting by Investment Advisers, Investment Advisers Act Release No. 2106, 68 Fed. Reg. 6585 (Feb. 7, 2003) (adopting Investment Advisers Act Rule 206(4)-6, 17 C.F.R. § 275.206(4)-6 (2006)); Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Securities Act Release No. 8188, 68 Fed. Reg. 6564 (Feb. 7, 2003) (adopting Investment Company Act Rule 30b1-4, 17 C.F.R. § 270.30b1-4 (2006), and related amendments to the applicable Investment Company Act forms).

⁶⁹ See Institutional Shareholder Services, *ISS 2006 US Proxy Voting Guidelines Summary*, <http://www.issproxy.com/pdf/US2006SummaryGuidelines.pdf> (summary of voting policies). By 2004 the then chairman of The Business Roundtable, a leading corporate lobbying group, had become so frustrated with ISS’s perceived anti-corporate bias that he urged the founding of a competitive alternative to ISS. “We have all seen,” he said, “the increasingly hostile recommendations from existing proxy advisory firms who continue to promote narrow interests at the expense of long-term shareholder value.” See Gretchen Morgenson, *Pfizer and the Proxy Adviser*, N.Y. TIMES, Apr. 21, 2006, at C1 (quoting Hank McKinnell). But ISS is less active than it used to be. See J.P. Donlon, *ISS Signals Strengthened Standards*, DIRECTORSHIP, March 2006, at 1, 9-10 (“ISS originally had a public image of being an activist organization, but this isn’t so today.”).

⁷⁰ See *ISS Voting Guidelines*, *supra* note 69, at 7; see also Institutional Shareholder Services, *ISS U.S. Corporate Governance Policy 2006 Updates 7* (2005), <http://www.issproxy.com/pdf/2006USPolicyUpdate.pdf>.

⁷¹ See *ISS Voting Guidelines*, *supra* note 69, at 14 (proxy contest guidelines are case-by-case). Specific examples are given below, at *infra* Part II.B.2.

owned by institutions that followed ISS voting recommendations.⁷² One consultant has similarly noted that “[m]any firms, especially those that practice purely quantitative or index investing, will vote in line with ISS’ recommendations . . . [while] some firms claim they vote on a case-by-case basis but will always vote with ISS.”⁷³ Getting a favorable ISS recommendation is therefore frequently essential to victory.⁷⁴ The ISS voting guidelines and evolving shareholder views have also gone some way to taking the sting out of corporate takeover defenses, including weakening poison pills and destaggering boards so that all directors stand for election every year.⁷⁵ In short, the ISS phenomenon has furthered and encouraged shareholder activism of all sorts, including especially hedge fund activism.⁷⁶

⁷² See Detailed Comments of Business Roundtable on the “Proposed Election Contest Rules” of the U.S. Securities and Exchange Commission 28-29 (Dec. 22, 2003), <http://www.sec.gov/rules/proposed/s71903/brt122203.pdf>. See also Robert D. Hershey, Jr., *A Little Industry With a Lot of Sway on Proxy Votes*, N.Y. TIMES, June 18, 2006, § 3, at 6 (noting that ISS recommendations affect the votes of “professional investors controlling \$25 trillion in assets – half the value of the world’s common stock”). ISS has begun to attract academic attention as well. See Paul Rose, *The Corporate Governance Industry* (SSRN Working Papers, July 27, 2006), <http://ssrn.com/abstract=902900> (detailed study and analysis).

⁷³ Chris Kettmann, *Predicting and Impacting the Proxy Vote* 3 (2005), <http://www.ashtonpartners.com/default.aspx?pageID=79>.

⁷⁴ See *infra* Part II.B.2; see also Andrew R. Brownstein & Trevor S. Norwitz, *Shareholder Activism in the M&A Context*, M&A LAW., June 2006, at 1, 3 (noting that ISS “cannot be regarded as a neutral party” and that the “fusion of aggressive hedge fund activism and the power of large institutional holders is a potent formula that can energize an activist campaign”).

⁷⁵ See Institutional Shareholder Services, *2005 Postseason Report: Corporate Governance at a Crossroads* 13-14 (2005), <http://www.issproxy.com> (subsection entitled “Anti-takeover Measures Under Greater Scrutiny”); Nathan & Lopez, *supra* note 11, at 43 (noting that “[r]ecent hedge fund successes can also be traced to the weakening of targets’ takeover preparedness, as well as directors’ increased sensitivity in a time of perceived greater vulnerability”). See also Elizabeth A. Ising, *Company Proposals to Declassify Boards of Directors*, INSIGHTS Sept. 2005, at 21 (declassification in response to institutional shareholder pressure); Victor I. Lewkow & Sarah G. ten Siethoff, *The Embattled Poison Pill*, INSIGHTS, Apr. 2005, at 13. But it does not do to overstate this point. Among the universe of US public companies tracked by ISS, as of year-end 2005 53% still had staggered boards and 35% had poison pills, in each case a change of less than three percentage points from 2003. See Patrick McGurn, *New Players, New Proposals, New Challenges: 2006 Proxy Season Preview/2005 Review* 18-20 (Jan. 11, 2006), http://www.thecorporatecounsel.net/webcast/2006_01_11. A recent study, moreover, has found that boards almost universally ignore even successful corporate governance shareholder proposals anyway, with the partial exception only of destaggering proposals. See Jason M. Loring & C. Keith Taylor, *Empirical Study, Shareholder Activism: Directorial Responses to Investors’ Attempts to Change the Corporate Governance Landscape*, 41 WAKE FOREST L. REV. 321, 331 (2006).

⁷⁶ ISS has also become significantly conflicted because it sells its activist-oriented services to institutions (thus creating issues for corporate managements) and to corporations (thus solving the issues created). See Institutional Shareholder Services, Inc., SEC No-Action Letter, [2004 Transfer Binder] Fed. Sec. L. Rev. (CCH) ¶ 78,845 (Sept. 15, 2004) (failing to

Finally, a series of recent decisions by the Delaware courts, where most public companies are incorporated,⁷⁷ have preserved for hedge fund activists the right to enjoy the fruits of electoral victory. Shareholders' voting rights occupy a special place in Delaware corporate law. The Delaware Supreme Court recently confirmed in *MM Cos. v. Liquid Audio, Inc.*⁷⁸ the validity of the strict *Blasius*⁷⁹ "compelling justification" standard for board action taken with the primary purpose of interfering with the effective exercise of shareholders' voting rights. Defensive tactics such as expanding the board and filling the resulting vacancies on the eve of a proxy vote to dilute a dissident's franchise are consequently proscribed, as is adding a mid-proxy-contest supermajority vote requirement to foil a dissident's efforts to amend the bylaws.⁸⁰ Other Delaware decisions have effectively eviscerated the anti-takeover effectiveness of the poison pill against proxy contests.⁸¹

The only discouraging word here is Sarbanes-Oxley.⁸² Finding candidates willing to serve on a dissident slate has always been difficult, and this bit of what Roberta Romano has called "quack corporate governance" has not made this task any easier.⁸³ The SEC's implementing rules have

get a blanket waiver of these conflicts under the Investment Advisers Act). ISS's power and conflicts are attracting increasing notice. See, e.g., NYSE Proxy Working Group, *Report and Recommendations* 29 (June 5, 2006), http://www.nyse.com/pdfs/REVISED/_NYSE_Report_6_5_06.pdf (recommending formal SEC study of "the role these [proxy advisory] groups play in the proxy voting process").

⁷⁷ See Kent Greenfield, *Democracy and the Dominance of Delaware in Corporate Law*, LAW & CONTEMP. PROBS., Autumn 2004, at 167 (recent review and analysis).

⁷⁸ 813 A.2d 1118 (Del. 2003).

⁷⁹ *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988). See David C. McBride & Danielle B. Gibbs, *Interference with Voting Rights: The Metaphysics of Blasius Industries v. Atlas Corp.*, 26 J. CORP. L. 927 (2001) (comprehensive analysis).

⁸⁰ See *MM Cos.*, *supra* note 78 (new board vacancies); *Chesapeake Corp. v. Shore*, 771 A.2d 293 (Del. Ch. 2000) (supermajority bylaw provision).

⁸¹ See *Quickturn Design Sys., Inc. v. Mentor Graphics Co.*, 721 A.2d 1281 (Del. 1998) (invalidating poison pill that purported to delay dismantlement by new dissident directors); *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180 (Del. Ch. 1998) (effectively invalidating poison pill that purported to disable dismantlement by new dissident directors forever). Delaware's validation of the director-adopted poison pill has in any event always been premised on the ability of shareholders to elect directors of their own choosing, *i.e.*, to run a proxy contest unimpeded. See *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1355 (Del. 1985). The poison pill law in other states can be less friendly. See Dennis J. Block & Jonathan M. Hoff, *Dead Hand Poison Pills and Recent Variations*, N.Y.L.J., Nov. 19, 1998, at 5 (Georgia and Pennsylvania).

⁸² Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C.).

⁸³ See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005). See also Steven A. Seiden, *Calling Those With*

also cast a dark shadow of non-“independence” over any candidate put up by a holder of ten percent or more of a company’s stock.⁸⁴ And as anyone who has read this far no doubt already knows, “independence” is the key to the Sarbanes-Oxley corporate governance city.⁸⁵

II. EMPIRICAL STUDY AND REVIEW: HEDGE FUND ACTIVISM

All these legal changes have combined to open the door wide for a new, more aggressive kind of shareholder activism, and hedge funds have marched unhesitatingly through. The following pages examine what they actually do and how they do it.⁸⁶

A. Study Methodology

The methodology used is straightforward. Data for all 2005 (the first year hedge fund activism received widespread notice) and the first eight months of 2006 (both the cut-off for this Article and the unofficial end of the proxy season) were hand-gathered from press reports and information available from Institutional Shareholder Services and Georgeson Shareholders.⁸⁷ What is considered a “hedge fund” has already been described.⁸⁸ For purposes of the study, “hedge fund activism” is defined as

Fortitude: So You Need a Dissident Director, BUS. L. TODAY, Jan.-Feb. 1999, at 29 (finding dissident director candidates); Barry Augenbraum, *Should Directors Be Worried?*, INSIGHTS, Feb. 2005, at 21 (rhetorically asking why any executive would choose to serve on a public company board and why any lawyer would advise such service “in today’s climate”).

⁸⁴ See Standards Relating to Listed company Audit Committees, Securities Act Release No. 8220, 68 Fed. Reg. 18,788 (Apr. 16, 2003) (adopting Rule 10A-3, 17 C.F.R. § 240.10A-3 (2006), which provides that only ownership under 10% preserves independence). Others have noticed this absurdity, too. See Roberta S. Karmel, *Realizing the Dream of William O. Douglas – The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 141 (2005) (observing that a corporation’s large stockholders nonetheless have “the greatest incentive to assure” high compliance standards). But the New York Stock Exchange’s listing standards have no such bright-line test. See N.Y. STOCK EXCHANGE, LISTED COMPANY MANUAL, at Rule 303A.02 & Commentary (2004), <http://www.nyse.com/lcm> (noting that “as the concern is independence from management, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding”).

⁸⁵ For a recent critical analysis, see Note, *Beyond “Independent” Directors: A Functional Approach to Board Independence*, 119 HARV. L. REV. 1553 (2006).

⁸⁶ A summary of the data collected appears as the Appendix at the end of this Article.

⁸⁷ See Georgeson Shareholder, *Annual Corporate Governance Review*, *supra* note 18; Institutional Shareholder Services, Inc., *2005 Postseason Report: Corporate Governance at a Crossroads* (2005), <http://www.issproxy.com/pdf/2005PostSeasonReportFINAL.pdf>. See also Patrick McGurn, *supra* note 75.

⁸⁸ See *supra* text at notes 20-21.

any actual or overtly threatened proxy contest or any other concerted and direct attempt to change the fundamental strategic direction of any solvent United States public corporation other than a mutual fund. For example, any campaign using such phrases as value “maximization” or “enhancement” is included; conversely, mere sponsors of corporate governance shareholder resolutions are excluded.⁸⁹ Once a situation was identified, virtually every filing with the SEC by every participant was reviewed to obtain details (which often remain under or unreported) about the strategies and tactics used.⁹⁰ While diligent efforts were used to identify as many situations as possible, some have no doubt been missed. This is likely especially true for situations involving smaller companies or sparser press attention.

Although the data presented have not been deliberately “cherry picked” for hedge fund success, unsuccessful activist efforts and campaigns involving smaller companies inevitably garner less than their fair share of attention. A campaign that gets no traction dies unnoticed. Some subjective judgment is also involved here since every hopeful writer of a “Dear Management” letter, who might get noticed in the weekly *Barron’s* write-up of that week’s half-dozen or so “activist” Schedule 13D filers, can hardly be said to have mounted anything resembling a real campaign. Nevertheless, what follows is presented with the confidence that it at least is fairly indicative of the kinds of strategies and techniques actually used by hedge funds today. What these findings mean for corporate governance and regulation will then follow.

B. The Findings: Hedge Fund Activism Today

Despite all the press and attention lavished on hedge fund activism and its supposed evils and benefits, one of the most striking things about this study’s findings is how rarely activist efforts became full public attacks. Of the thousands of US public companies, only 49 seem to have become the subject of a significant hedge fund campaign during the 20 months examined. So whatever the eventual significance of hedge fund activism,

⁸⁹ If sponsoring shareholder resolutions constituted activism, then even Harvard law professors could be activists, as well as the usual run of labor unions, public pension funds and full-time corporate gadflies. See Mark Maremont & Erin White, *Stock Activism’s Latest Weapon*, WALL ST. J., Apr. 4, 2006, at C1 (reviewing innovative shareholder-resolution-based activist techniques used by Professor Lucian Bebchuk against eight public companies). See also *infra* notes 200-205 and accompanying text (reviewing labor union, public pension fund and individual activism through shareholder resolutions).

⁹⁰ Essentially all public company filings are available, sorted chronologically by company, through the SEC’s EDGAR search page. See <http://www.sec.gov/edgar/search/edgar/webusers.htm>.

today it represents less a *direct* meaningful problem for management America than an *indirect* sign of coming fundamental changes in United States corporate governance.⁹¹

1. Free Communication

As intimated in the legal introduction above,⁹² the most striking substantive finding is how Rule 14a-12's "free communication" provisions have transformed the hedge fund shareholder activism landscape. Of the 37 situations involving threatened or actual proxy or consent fights, the dissidents used the rule for written communications in 29. The eight remaining situations mostly involved either unusual circumstances such as a hostile consent solicitation (where the surprise attack is the favored tactic), a mainly verbal campaign against an unwanted merger or a fast settlement.⁹³ The funds' use of Rule 14a-12, moreover, has sometimes become so extreme that an entire proxy contest has occurred without the filing of any proxy statement at all, not even a preliminary one: Carl Icahn and the management of Time Warner fought it out for six months on the basis of Rule 14a-12 filings alone, finally culminating in an Icahn-led press conference at the St. Regis hotel in New York and a 348-page book full of supporting material presented by Icahn's investment banker, the venerable Bruce Wasserstein.⁹⁴ After all this, Icahn retired to count the votes he likely had, determined that they were not enough and threw in the towel after a barely face-saving settlement of getting two new independent directors added to the board and an increase in the company's existing stock buy-back program.⁹⁵ How could all this happen, practically a whole proxy contest, with no proxy statement? The second extreme Rule 14a-12 contest found in the study, Relational Investors' ten-month campaign against Sovereign

⁹¹ See *infra* Part IV.A. Cf. Bebchuk, *Letting Shareholders Set the Rules*, *supra* note 13, at 1784 n.2 (describing numerically small instances of proxy fights for control).

⁹² See *supra* text at notes 50-55.

⁹³ See, e.g., *infra* text at note 126 (settlement after consent solicitation at AirNet Systems); *infra*, text at notes 98 and 132 (oral campaign against merger at MCI); *infra* text at note 139 (fast settlement at Knight Ridder). Strangest of all was General Motors, where the insurgent claimed it was passive and yet somehow managed to threaten a proxy contest anyway to obtain a board seat. See Lee Hawkins, Jr., *Kerkorian May Turn Up Heat on GM*, WALL ST. J., Sept. 22, 2005, at A3. For the tactics in consent solicitations, see Eric S. Robinson, *Defensive Tactics in Consent Solicitations*, 51 BUS. LAW. 677 (1996).

⁹⁴ See Matthew Karnitschnig, *Icahn Ends Effort to Take Control of Time Warner*, WALL ST. J., Feb. 17, 2006, at A1 (summarizing contest); Time-Warner, Inc., *Soliciting Material Filed By Non-Registrant (Schedule 14A)* (Dec. 7, 2005) (Icahn's Rule 14a-12 filing of Bruce Wasserstein's 348-page presentation).

⁹⁵ See Matthew Karnitschnig, *Time Warner, Icahn Reach Accord*, WALL ST. J., Feb. 18-19, 2006, at A3.

Bank, was at least conducted based in part on the filing of a preliminary proxy statement.⁹⁶

Two further and important aspects of the Rule 14a-12 phenomenon are worth noting. First, months-long contests with all sorts of material being distributed to shareholders ineluctably involve frequent and extensive conversations with those being solicited. As described above, entire hotel ball rooms full of shareholders can be addressed. Under Rule 14a-12, these conversations remain essentially unregulated.⁹⁷ The study found one contest, Deephaven Capital Management's unsuccessful attempt to block the MCI-Verizon merger last year, where a hard-fought campaign appears to have been based solely on oral communications.⁹⁸ Second, with the SEC no longer prescreening any of this material, sophisticated and one-sided advocacy rules the day, as the SEC has evidently chosen to direct its resources elsewhere.⁹⁹ Certainly getting practically daily filings over a period of months, let alone a 348-page financial presentation book, past the SEC never would have happened on anything like a real-time basis before the rules modernization.¹⁰⁰

2. Activist Size, Wolf Pack Tactics and the Advisory Firms

After the near ubiquity of Rule 14a-12, the study's next most interesting finding is the size of the funds' direct and indirect shareholdings. Of all the situations reviewed, only five involved hedge fund activists with less than a 4.9% stake. Twenty-two activists had at least a 9.5% stake.¹⁰¹ A higher

⁹⁶ See Jesse Eisinger, *Sovereign Bancorp's Takeover Deal Looks Like a Dis to Shareholders*, WALL ST. J., Nov. 2, 2005, at C1 (summary of contest, including Relational's preliminary proxy filing); David Enrich, *Sovereign, Relational Crusaded Right Up to Their Uneasy Truce*, WALL ST. J., Mar. 24, 2006, at C3 (describing settlement).

⁹⁷ See *supra* text at note 51.

⁹⁸ See Andrew R. Sorkin & Ken Belson, *A Campaign to Derail Verizon-MCI Deal*, N.Y. TIMES, June 15, 2005, at C2. The insurgents never filed any written material under Rule 14a-12.

⁹⁹ See *supra* text at notes 29-31.

¹⁰⁰ See Regulation of Security Holder Communications, Exchange Act Release No. 29,315, [1991 Transfer Binder] Fed. Sec. L. Rev. (CCH) ¶ 84,811, at Part III.B.1 (June 17, 1991) (noting that both "management and insurgent groups alike have criticized [preclearance] . . . as interfering unduly with effective communication with shareholders"). For an authoritative account of the old pre-clearance procedures, see EDWARD R. ARANOW & HERBERT A. EINHORN, PROXY CONTESTS FOR CORPORATE CONTROL 138-59 (2d ed. 1968) (superseded).

¹⁰¹ There is a reason many activists deliberately stay safely under 10%. Section 16 of the Securities Exchange Act effectively makes short term trading with ownership over this level impossible. See 15 U.S.C. § 78p (2000 & Supp. III 2003).

stake makes a bigger publicity megaphone and gives any campaign a good start when it comes to counting votes. It also helps to have fellow, like-minded investors with still more shares. Three of the situations studied show disclosed ownership by a handful of institutions of over half the outstanding shares.¹⁰²

Failing this kind of already locked-up vote, an activist can attract a “wolf pack” of other hedge funds interested in the same prey but who are careful not to form a Schedule 13D group.¹⁰³ Precise data about wolf packs are impossible to obtain since ungrouped holders do not have to disclose anything, but at least several of the situations studied appear to have involved these beasts. Thirteen involved either two or more mutually supportive but separate Schedule 13D filers or other reported pack activity. In the two-week long successful effort to force a sale at Knight Ridder, for example, the company’s largest shareholder was joined just two days after the announcement of its campaign by two other new Schedule 13D filers with the same goal. What started out as a 19% stake effectively grew to 37% in just 48 hours. The campaign had already succeeded before it had hardly begun.

From a purely legal point of view, it is especially noteworthy that two of these packs produced a joint slate of directors while somehow avoiding forming a group. This kind of close but non-group forming pseudo-cooperation would have been inconceivable in a prior era,¹⁰⁴ and shows how intimate shareholders can get without running afoul of the rules. Note, too, that the company in the Bally proxy fight attempted to sue on this point in both federal and state court, but to no avail.¹⁰⁵

The Institutional Shareholder Services phenomenon described earlier¹⁰⁶

¹⁰² It is also highly likely that there were many more than only three. Professional proxy solicitors make part of their living by using the often stale and always difficult-to-interpret information provided by Form 13F reports under Rule 13f-1, 17 C.F.R. § 240.13f-1 (2006), to estimate ownership by institutions that stay under the 5% level used for Schedule 13D, Schedule 13G and proxy statement disclosure purposes.

¹⁰³ See *supra* text at notes 43-46 and 59-66.

¹⁰⁴ Compare Briggs, *supra* note 1, at 137-38 (detailed legal analysis), with *supra* text at note 64 (citing recent case appearing to allow joint slate).

¹⁰⁵ See *Bally Total Fitness Holding Corp. v. Liberation Invs., L.P.*, No. 05-841-JJF, 2005 U.S. Dist. LEXIS 34897 (D. Del. Dec. 22, 2005) (denying motions for preliminary injunction and expedited discovery in “group” proxy and Schedule 13D case); *Bally Total Fitness Holding Corp.*, Definitive Additional Materials (Schedule 14A) (Jan. 10, 2006) (text of state court complaint attempting to use alleged “group” formation as poison pill trigger); *Definitive Additional Materials Filed By Non-Registrant (Schedule 14A)* (Jan. 1, 2006) (two filings on this date both describing court’s *de facto* rejection of suit).

¹⁰⁶ See *supra* text at notes 67-76.

appears to help add wolves to the pack. ISS backed the dissidents in twelve proxy fights for board seats and the dissidents won eleven; ISS backed management in three other contests, one of which the dissident also won. Although its published proxy contest guidelines reflect a case-by-case policy,¹⁰⁷ in practice ISS thus appears more than willing to back dissidents. When it does, they win. Or at least it has to help since whenever elections are involved, every vote counts. Even if ISS's evident policy of issuing a recommendation only two weeks or so before a scheduled proxy vote means that it misses most situations,¹⁰⁸ its known leanings will inevitably influence everything from pre-proxy value maximization campaigns to outright proxy contest settlements. After all, how contestants think a vote will likely go will inevitably drive their settlement decisions.

ISS's earlier described indirect influence on antitakeover defenses¹⁰⁹ also appears to have fatally weakened one of the predated companies in the survey, Six Flags, Inc. The dissident in this contest was able mount a consent solicitation to take over effective control of the board of directors because the company's charter failed to prohibit action by shareholder written consent.¹¹⁰ Since only the shareholders can amend a charter, Six Flags would have had to have had its shareholders vote to take away from themselves the right to act by consent. ISS has a policy of always recommending a vote against such a charter amendment.¹¹¹ Current investor sentiment these days also generally runs in the same direction. So trying to fix the vulnerability would have been futile, and the company remained open to an activist's attack.

The object nevertheless remains to persuade, and it appears that hedge fund activists are taking advantage of their opportunities in new ways. ISS has come to be treated almost as sort of latter-day cross between Solomon and the Pied Piper of Hamelin before which contestants make road-show

¹⁰⁷ See *supra* note 71 and accompanying text.

¹⁰⁸ This conclusion is drawn from the study data. Situations missed include settled fights (if the contest stops early enough) and generic value enhancement or maximization campaigns (no vote at all).

¹⁰⁹ See *supra* text at notes 72-76.

¹¹⁰ See Six Flags, Inc., Definitive Proxy Statement Filed By Non-Registrant (Schedule 14A) (Oct. 19, 2005). Section 228 of the Delaware General Corporation Law permits shareholder action by written consent unless the charter specifically prohibits such action. DEL. CODE ANN. tit. 8, § 228 (2001). Other "pure" shareholder solicitations in the survey were directed against companies subject to Colorado and Ohio corporate law, which statutorily give shareholders the right to call a special meeting, and against a New York company with an old similarly permissive bylaw. See Computer Horizons, Inc., Definitive Proxy Statement Filed By Non-Registrant (Schedule 14A) (Sept. 14, 2005).

¹¹¹ See *ISS Voting Guidelines*, *supra* note 69, at 15.

financial presentations and, in at least one instance, purely legal arguments.¹¹² Four activists in the survey took the essentially unprecedented step of hiring high-profile investment bankers.¹¹³ And it seems that sophisticated slide shows, duly filed with the SEC, have become standard practice. One activist went so far as to prepare a formal white paper.¹¹⁴

3. Other Findings

Money also helps any campaign and, as described in the Introduction above, hedge funds now have a lot of it.¹¹⁵ Four of them used their financial clout to offer to buy their targets outright, perhaps more in the hope of shaking things up than in actually completing a transaction.¹¹⁶ A fifth actually did so. In a somewhat aggressive use of the new short-form Schedule 13G rules for passive investors,¹¹⁷ Edward Lampert's ESL Investments negotiated a purchase of Sears over a period of several weeks without disclosing anything at all. Then, only after the acquisition agreement was actually signed, was a full Schedule 13D filed.¹¹⁸ ESL did get sued over this tactic – how does a supposedly “passive” investor wind up buying a whole company? – but by then it was too late.¹¹⁹ The acquisition was already an accomplished fact.

¹¹² See Cenevo, Inc., Definitive Additional Materials Filed By Non-Registrant (Schedule 14A) (Aug. 24, 2005) (letter brief submitted to ISS presenting dissident's case on directors' fiduciary duties).

¹¹³ See Der Hovanesian, *supra* note 3, at 72 (observing that activists are “recruiting new allies on Wall Street,” and citing the investment banks hired in the Wendy's and Time Warner situations); Gregory Zuckerman, *Activist Hedge Funds Win Fans on Wall Street*, WALL ST. J., May 8, 2006, at C1 (citing the investment banks hired in the Six Flags and Acxiom situations).

¹¹⁴ See Wendy's International, Inc., Schedule 13D filed by Trian group (Dec. 12, 2006) (paper entitled “Wendy's International, Inc. – A Recipe for Successful Value Creation”).

¹¹⁵ See *supra* text at notes 6-7.

¹¹⁶ See Acxiom Corp., Schedule 13D filed by ValueAct Capital (July 14, 2005); Circuit City Stores, Inc., Schedule 13D filed by Highfields Capital Management, L.P. (Mar. 8, 2005); Houston Exploration Co., Schedule 13D filed by Jana Partners (June 22, 2006); Mylan Laboratories, Inc., Soliciting Material Filed By Non-Registrant (Schedule 14A) (June 1, 2005).

¹¹⁷ See *supra* text at notes 59-62.

¹¹⁸ See Sears, Roebuck and Co., Schedule 13D filed by ESL Investments, Inc. (Nov. 19, 2004) (cover-page box indicating a switch from Schedule 13G to Schedule 13D is checked).

¹¹⁹ Such a result is possible if the investor only becomes *definitively* non-passive ten days or less before filing a Schedule 13D. See *supra* text at notes 43-49 and 59-62. As of this writing, the litigation over whether ESL was really passive while it relied on Schedule 13G is pending. See *Levie v. Sears Roebuck & Co.*, No. 04C7643, 2006 U.S. Dist. LEXIS 12725 (N.D. Ill. Mar. 22, 2006) (denying motion to dismiss).

At this point, another of the survey's findings necessarily enters the discussion: for all its public-relations nastiness, hedge fund activism rarely results in campaign-time litigation. Although several situations appear to have involved significant law suits, only three of them appear to have been company-instigated. It is not hard to guess why this might be so. Many knowledgeable observers believe that suing hedge fund activists is "more likely to alienate other shareholders these days."¹²⁰ Just two of these disputes produced truly full-out litigation. The court proceedings in the Sovereign Bank contest basically went nowhere, but left the insurgent struggling with only mixed success against Pennsylvania's particularly unfriendly corporate regime.¹²¹ The company's poison pill and Schedule 13D "group" lawsuits in the Bally contest, on the other hand, also went nowhere while seeming actually to help the insurgents.¹²²

Finally, the survey found hedge fund activists using a number of other tactics that will already be familiar to close observers of the shareholder activism scene. The short slate rule adopted with the 1992 proxy reforms described earlier¹²³ apparently continues to see little actual use, as it appears only twice.¹²⁴ Written material under the 1992 "free speech" rule appears in only one contest.¹²⁵ Another dissident used a public solicitation of consents to call a special meeting (the dissident by itself did not own enough shares)

¹²⁰ See Phyllis Plitch, *Lawyers See No Poison Pill To Feed Hedge Fund "Wolf Packs,"* CORP. GOVERNANCE, Dec. 21, 2005, at 4, 19 (summarizing views of Wall Street lawyers); see also Briggs, *supra* note 1, at 135-36 (subsection entitled "Litigation: the New Risk Calculus"); Katz & McIntosh, *supra* note 4, at 7 (noting lack of recent anti-hedge fund litigation and commenting that "a scorched-earth litigation campaign may alienate important shareholders and turn the tide against management").

¹²¹ See Eric Dash, *Sovereign Bank Settles Dispute with Shareholder*, N.Y. TIMES, Mar. 22, 2006, at C18 (summarizing litigation and settlement). For a succinct description of the antitakeover aspects of Pennsylvania corporate law, see William G. Lawlor, Peter D. Cripps & Ian A. Hartman, *Doing Public M&A Deals in Pennsylvania: Minesweeper Required*, 38 REV. SEC. & COMM. REG. 191 (2005).

¹²² After the threatened filing of the suits, the principal dissident's fight letters regularly cited them as an example of the company's poor judgment, and noted that they also apparently helped influence ISS to recommend voting for the dissidents. See, e.g., Bally Total Fitness Holding Corp., Definitive Additional Material Filed By Non-Registrant (Schedule 14A) (Jan. 17, 2006) (fight letter prominently noting ISS's disapproval of the company's "extremely rare" and "potentially extreme" attempted application of its poison pill to thwart a stockholder vote in a proxy contest).

¹²³ See *supra* text at notes 38-40.

¹²⁴ See BioMarin Pharmaceutical Inc., Definitive Proxy Statement Filed By Non-Registrant (Schedule 14A) (May 23, 2005) (proxy card using short slate rule); H.J. Heinz Co., Definitive Proxy Statement Filed By Non-Registrant (Schedule 14A) (July 12, 2006) (same).

¹²⁵ See Houston Exploration Co., Notice of Exempt Solicitation filed by Jana Partners (Apr. 24, 2006) (opening salvo in longer campaign).

in an ultimately successful attempt to bluff management into a settlement.¹²⁶ And on at least two occasions, dissidents used Hart-Scott-Rodino antitrust notification filings, which are generally required only of active investors, to indicate their seriousness of purpose as an apparent prelude to starting settlement discussions.¹²⁷

III. CONFLICTS OF INTEREST AND FULL DISCLOSURE

The central question running throughout any examination of hedge fund activists is this: Can we trust them?¹²⁸ According to critics, they are short-term traders whose interests frequently diverge from those of a company's other shareholders.¹²⁹ Worse still, their secretive and complex trading strategies can sometimes mean that they actually may want a company's strategies to fail.¹³⁰ There is indeed practically a whole catalogue of possible disclosed and undisclosed sins that a hedge fund (or anyone else) might commit in the course of an activist campaign, and hedge funds seem to have been accused of committing them all. Based on the data gathered in the survey, however, there appears to be very little fire beneath all this smoke, and what there is seems largely contained by present-day regulations.

A. Hedged and Other Adverse Positions

Perhaps the most serious charge that can be leveled at hedge fund activists is that their trading strategies may encourage them to destroy corporate value rather than create it. What could possibly be worse for the

¹²⁶ See AirNet Systems, Inc., Definitive Proxy Statement Filed By Non-Registrant (Schedule 14A) (May 11, 2005).

¹²⁷ See General Motors, Inc., Schedule 13D filed by Tracinda group (Sept. 21, 2005); Press Release, Kerr McGee Corp, Kerr-McGee Receives HSR Notice from Icahn (Feb. 18, 2005), http://www.kerr-mcgee.com/media/news/archive/news205/news_2050218.htm. The passive investor exception from the Hart-Scott-Rodino filing rules for under-10% holders is at 16 C.F.R. § 802.9 (2006). See 1 STEPHEN M. AXINN *ET AL.*, ACQUISITIONS UNDER THE HART-SCOTT-RODINO ANTITRUST IMPROVEMENTS ACT § 6.07 (rev. ed. 2005); Malcomb R. Pfunder, *Shareholder Activism and the Hart-Scott-Rodino Act Exemption for Acquisitions of Voting Securities Solely for the Purposes of Investment*, ANTITRUST, Summer 2006, at 74.

¹²⁸ Cf. Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987 (1994) (an early elucidation of good investors gone bad).

¹²⁹ See *supra* note 4 (quoting Martin Lipton); Anabtawi, *supra* note 14, at Part III.A (subsection entitled "Short-Term Versus Long-Term Shareholders").

¹³⁰ See Anabtawi, *supra* note 14, at Part III.E (subsection entitled "Hedged Versus Unhedged Shareholders"); Hu & Black, *supra* note 27 (describing hedging and vote buying techniques); Andrew M. Kulpa, *The Wolf in Shareholder's Clothing*, 6 U.C. DAVIS. BUS. L.J. 4 (2006) (hedge funds as corporate governance villains).

other shareholders, especially if they have no inkling that their activist hero is really short the stock?

The survey found very little evidence of these kinds of games, just six possibly questionable situations. In three of these, the activist had a trading position in a merger counterparty: ESL at Sears was long and supported the merger; Icahn at Mylan Labs was short and opposed it; and Deephaven at MCI was short and also opposed it.¹³¹ Only Deephaven seemed to provoke skepticism on the part of other investors, and this may have been because the fund further disclosed positions both in MCI's bonds and in a competing acquirer's stock and bonds. Deephaven's campaign consequently seemed profoundly, almost impenetrably tactical and so won the support of neither ISS nor of many other investors.¹³² Evidently MCI's investors could read, and they were not easily led astray.

Two of these six activists were hedged, and leave the disinterested observer wondering whether all politics must indeed be local. The dissident fund in a proxy contest for three board seats at Exar Corporation last year disclosed that it held less than one percent of the stock and that 96 percent of the shares were "boxed" or fully hedged with offsetting short positions.¹³³ The dissident was thus almost completely indifferent to how the company performed since a "boxed" position is capable of generating no further profit or loss; nevertheless, ISS recommended a vote for the fund anyway and it won. The seemingly far more complicated situation with Carl Icahn's advisee in his contest at Time Warner, on the other hand, seems to have been interpreted as nothing more than a clever way of acquiring an interest in the most shares for the least risk and cost.¹³⁴ The sixth activist, the author of the value enhancement white paper in the Wendy's campaign, disclosed that its interest in the company was mostly in privately negotiated put and call options that appear to have been entered into as a short-term financing device.¹³⁵ Here, too, the complexity of the dissident's position seems to

¹³¹ See Sears Schedule 13D, *supra* note 118; Mylan Labs, Inc., Schedule 13D filed by High River group (Dec. 17, 2004); MCI, Inc., Definitive Proxy Statement (Schedule 14A) (Sept. 1, 2005).

¹³² See MCI, Inc., Current Report (Form 8-K) (Oct. 7, 2005) (reporting that the merger received the support of 88% of the votes cast and 65% of the stock outstanding).

¹³³ See Exar Corp., Definitive Proxy Statement (Schedule 14A) (Oct. 3, 2005).

¹³⁴ See Liz Rappaport, *UBS Note Sale to Give Icahn More Sway Over Time Warner*, WALL ST. J., Feb. 3, 2006, at C4; Time Warner, Inc., Schedule 13D filed by Icahn advisee (Feb. 16, 2006).

¹³⁵ See Schedule 13D, *supra* note 114.

have caused little comment or concern.¹³⁶

The allegedly value-destroying short term approach of many hedge funds activists is harder to analyze, but again seems to cause little concern for other investors.¹³⁷ As noted in the Introduction,¹³⁸ hedge funds are under intense pressure to perform now, today, but this does not exactly make them all that different from many other Wall Street institutions. Even the most obvious and public short-term versus long-term conflict in the survey apparently drew little or no publicly reported fire from other investors: the dissident in the Knight Ridder sell-the-company campaign was widely said to be angling for a \$300 million performance bonus payment from its corporate parent, but few seemed to care. Knight Ridder was sold anyway, and for a price that many felt was disappointing.¹³⁹

Although the corporate governance literature is full of dire warnings about how large shareholder activists might seek to divert corporate monies to themselves,¹⁴⁰ the survey did not find evidence of any more direct adverse hedge fund behavior, such as greenmail or other similar conflicts. Several hedge funds in the survey managed to get some of their proxy contest expenses reimbursed, but this has been normal and customary

¹³⁶ See Andrew R. Sorkin, *An Investor Takes Aim At Wendy's*, N.Y. TIMES, Dec. 13, 2005, at C1.

¹³⁷ According to one hedge fund manager, “the ‘short-term’ versus ‘long-term’ distinction is often a nonsensical cover-up for poor performance from managers who have failed to deliver results over either horizon.” Barry Rosenstein, *Activism Is Good for All Shareholders*, FIN. TIMES, Mar. 10, 2006, at 17. Many academic commentators also seem unconvinced by the supposed evils of short-term investing. See, e.g., MARK J. ROE, STRONG MANAGERS, WEAK OWNERS 242-43 (1994) (characterizing “short termism” as little more than a “debater’s weapon” deployed by defenders of corporate managers). Some even actively defend short-termism. See Joe Nocera, *A Defense of Short-Termism*, N.Y. TIMES, July 29, 2006, at B1, B8 (“[F]or all the anecdotal evidence of short-termism and its effects, there is not a lot of empirical data to back it up.”). On the other hand, an SEC commissioner recently questioned “whether . . . short-time investors should be entitled to shareholder rights in outright conflict with long-term investors.” Roel C. Campos, Speech by SEC Commissioner: Remarks before the SIA-Hedge Fund Conference (Sept. 14, 2005), www.sec.gov/news/speech/spch091405rcc.htm.

¹³⁸ See *supra* text at note 8.

¹³⁹ See Joseph T. Hallinan & Dennis Berman, *Knight Ridder to Decide on Sale*, WALL ST. J., Mar. 13, 2006, at A2; Joseph T. Hallinan, *Legg-Mason-PCM Deal Included Payout Pact That May Explain Timing on Knight Ridder Push*, WALL ST. J., Nov. 23, 2005, at C1 (noting approaching deadline for \$300 million bonus performance measuring period).

¹⁴⁰ See, e.g., Anabtawi, *supra* note 14, at Part IV; Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 855-61 (1992); Rock, *supra* note 128, at 995-99; see also David A. Skeel, *Corporate Anatomy Lessons*, 113 YALE L.J. 1519, 1529 (2004) (noting that in places like Germany and Japan “[b]lockholders may use their influence to direct benefits to themselves at the expense of the company’s other, scattered shareholders”).

practice for decades.¹⁴¹ Only one fund appears to have become involved in a more complicated situation. Barrington Capital started out with a board seat at Register.com, lobbied unsuccessfully for a sale, and then started a proxy contest for control. Barrington ended up abandoning its proxy contest partner in mid-fight, settling for the reimbursement of up to \$500,000 of its expenses, and joining the company's cash-short eventual acquirer as an equity participant. The company's special committee evidently pushed hard for the settlement and seems to have worked to squeeze every last ounce of possible juice from the buying group.¹⁴² Nothing in this admittedly somewhat involved situation appears to resemble greenmail.¹⁴³

B. Full Disclosure of Adverse Positions

The review thus far of hedge fund activism has shown that hedge fund activists rarely pursue strategies that cannot withstand the light of day.¹⁴⁴ But we really should not be surprised. Hedge funds know as well as anyone else that sunlight is the best disinfectant. With only one recent known exception,¹⁴⁵ a competently advised fund that is truly bent on behavior that might not do well in the sun is simply not going to purchase enough shares to require a Schedule 13D filing, let alone start a high-profile proxy fight. It necessarily seems to follow that current SEC disclosure laws *as applied to hedge fund activists*¹⁴⁶ already effectively require full disclosure of iffy trading strategies, or much of this Article would not exist. But how true is this really and could the rules do with some improvement?

¹⁴¹ See, e.g., Shopko Stores, Inc., Current Report (Form 8-K) (Sept. 29, 2005) (\$300,000 expense reimbursement). Reimbursements, both as a result of a settlement and after an outright victory, have been part of the proxy statement disclosure requirements for decades. See 17 C.F.R. § 240.14a-101, Item 4(b) (2006).

¹⁴² See Register.com, Inc., Definitive Proxy Statement (Schedule 14A), at 5-8, 18 (Sept. 20, 2005).

¹⁴³ Possible hedge fund impropriety once in control of a company's board presents a different set of problems. See *infra* text at notes 242-47.

¹⁴⁴ The only doubtful case turned up is MCI. See *supra* text at notes 131-32.

¹⁴⁵ See *infra*, text at notes 158-60; Ianthe J. Dugan, *Hedge Funds Get Warning on Use of Merger Move*, WALL ST. J., Jan. 11, 2006, at C1 (report that one of funds involved in the Mylan-Icahn situation has received a Wells notice from the SEC's enforcement division questioning the fund's Schedule 13D disclosure of its alleged vote buying); Andrew R. Sorkin, *Nothing Ventured, Everything Gained*, N.Y. TIMES, Dec. 2, 2004, at C1 (describing the situation).

¹⁴⁶ Whether current SEC disclosure regulations sufficiently police ordinary hedge fund trading activity is an extraordinarily complex question beyond the scope of this Article. See Hu & Black, *supra* note 27.

The disclosure rules in Rule 14a-12 battles and outright proxy fights¹⁴⁷ require only a brief analysis. Based on a review of all the proxy filings in the survey, it would seem that the SEC's existing rules mandate the disclosure of essentially everything that a hedge fund might otherwise want to keep secret. Any other view would be practically unthinkable. As authoritatively interpreted by the Supreme Court, the SEC's proxy antifraud rule mandates the inclusion of all "material" facts, and a fact is deemed material "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."¹⁴⁸ As we have seen, lawyers who draft proxy statements for activist hedge funds think that people would want to know if their clients own bonds or are short, hedged, or invested in the other side of a proposed transaction.¹⁴⁹ The Second Circuit, moreover, apparently agrees.¹⁵⁰ It recently stopped a proxy solicitation from going forward under the "free speech" rule, that is without a proxy statement, at least in part because it was not satisfied with how the dissident hedge fund had disclosed its short derivative position in a merger counterparty's bonds. The court rather dryly observed that the hedge fund's interests in defeating the company's proposed merger consequently "may or may not be in sync with the interests of other . . . shareholders."¹⁵¹ The actual proxy statement line-item disclosure requirement in this area then becomes almost besides the point. It rather inadequately references only "securities of the [company] which the [proxy] participant owns" and therefore remains an almost quaint remnant of a prior, simpler time.¹⁵²

If there is a five-percent shareholder but no proxy statement, Schedule 13D rules the day, and here the analysis gets somewhat more complicated. The Schedule requires an investor to disclose any "contracts, arrangements, [or] understandings . . . with respect to any securities" of the company in addition to, as described earlier, its true purpose and intentions in holding

¹⁴⁷ The same information about proxy participants' shareholdings is required to be included, directly or through incorporation by reference, in Rule 14a-12 material as in a full proxy statement. See 17 C.F.R. § 240.14a-12(a)(1) (2006).

¹⁴⁸ 17 C.F.R. § 240.14a-9 (2006); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (leading "materiality" case in all United States securities law).

¹⁴⁹ See *supra* Part III.A.

¹⁵⁰ See *MONY Group, Inc. v. Highfields Capital Mgmt., L.P.*, 368 F.3d 138 (2d Cir. 2004).

¹⁵¹ 368 F.3d at 148.

¹⁵² 17 C.F.R. § 240.14a-101, Item 5(b)(1) (2006). This formulation was adopted as part of the original promulgation of the current proxy rules in 1956. See Release No. 5276, *supra* note 23. See generally Frank Partnoy, *Adding Derivatives to the Corporate Law Mix*, 34 GA. L. REV. 599, 599 (2000) (opening sentence declaring that "[i]n less than three decades, financial derivatives have changed the world").

the stock.¹⁵³ Disclosure of short positions,¹⁵⁴ cash-settled derivatives¹⁵⁵ and positions of any kind in a proposed merger counterparty¹⁵⁶ are not *directly* called for. But in the context of a high-profile activist effort, the “purpose” disclosure requirement in fact covers just about the same waterfront as the proxy rules just discussed. After all, if a filer is hedged, short or otherwise conflicted, it is at least highly doubtful that this would not affect its purpose in holding the stock. The SEC has as much as said so twice in explicitly warning that a short or futures transaction may constitute “a possible shift in purpose” under the rules.¹⁵⁷ The only shareholder activist in recent memory known to have skirted the rule is Perry Corporation in the Carl Icahn-Mylan Labs situation previously mentioned.¹⁵⁸ Perry’s extraordinarily opaque filing disclosed that it had purchased nearly ten percent of Mylan on a fully hedged basis, that it also owned shares in Mylan’s proposed merger partner, and that it supported the merger, but did not say how it had hedged.¹⁵⁹ Wall Street observers immediately understood that Perry was effectively buying votes to support a merger Icahn opposed, but the SEC is nonetheless apparently bringing civil enforcement proceedings.¹⁶⁰ The conclusion that

¹⁵³ 17 C.F.R. § 240.13d-101, Items 4 & 6 (2006); *supra* text at notes 47-49.

¹⁵⁴ See H. COMM. ON GOV’T OPERATIONS, SHORT-SELLING ACTIVITY IN THE STOCK MARKET: MARKET EFFECTS AND THE NEED FOR REGULATION, H.R. REP. NO., 102-414, pt. 1, at 23 (1991), *reprinted in* Fed. Sec. L. Rep. (CCH) No. 1483, at 23 (Jan. 22, 1992) (“short sellers who acquire a short position of this [five percent] magnitude in a company’s stock are not subject to any similar [to Schedule 13D] reporting requirement”); Public Disclosure of Material Short Security Positions, Exchange Act Release No. 29,278, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,806 (June 7, 1991) (acknowledging that Schedule 13D “require[s] public reporting of material long (but not short) positions”).

¹⁵⁵ A purely cash-settled derivative is evidently not a contract “with respect to any securities of the company,” and is generally, in the author’s experience, not disclosed absent special circumstances. See Hu & Black, *supra* note 27, at 868 (same). But the SEC has issued a preliminary interpretative release in a closely related context stating that a purely cash-settled security future “would be a ‘contract . . . with respect to . . . securities of the [company]’ under Item 6.” Securities Act Release No. 8107, 67 Fed. Reg. 43,234, 43,240 (June 27, 2002).

¹⁵⁶ Although Schedule 13D does not require any disclosure at all with respect to securities of another company, such a second filing of course would be required if the other position independently reached the five-percent filing threshold and otherwise fell within the ambit of the rules.

¹⁵⁷ See Release No. 8107, *supra* note 155, at 43,240 (security futures); Release No. 29,278, *supra* note 154, at 88 n.29 (short positions).

¹⁵⁸ See *supra* text at notes 131 and 145.

¹⁵⁹ See Mylan Labs., Inc., Schedule 13D filed by Perry (Nov. 29, 2004).

¹⁶⁰ See *supra* note 145. Icahn also sued Perry alleging inadequate Schedule 13D disclosure and “vote buying” in an action subsequently dismissed. See High River L.P. v. Mylan Labs., Inc., 353 F. Supp. 3d 487, 490 (M.D. Pa. 2005) (preliminary proceedings).

Schedule 13D effectively calls for as full disclosure from a hedge fund activist as the proxy rules therefore seems sound.

If there is a ten percent shareholder, the SEC's insider ownership reporting rules do specifically require disclosure of derivative positions as well as direct stock ownership, and outlaw short sales entirely.¹⁶¹ The rules do not cover straight debt or holdings in other companies. More to the point, many hedge fund activists choose not to exceed the ten percent threshold in the first place.¹⁶² The insider reporting rules therefore play but a minor role in hedge fund activism, especially in light of the already fairly complete disclosure mandated by Schedule 13D and the proxy rules just described.

Finally, as this Article has shown, hedge fund activism with an ownership level below the five percent Schedule 13D threshold only happens relatively rarely.¹⁶³ It is not hard to see why. An activist with such a small stake typically has a commensurately difficult time gaining enough attention to find its way into this Article's data base at all, let alone enough attention and (if need be) votes actually to succeed on the merits.¹⁶⁴ A small shareholder activist also suffers proportionately more than a large one from collective action and free-riding problems.¹⁶⁵ In other words, an activist "bears most of the cost of a proxy campaign, but receives only a pro rata share of the gains from success, while other shareholders can free ride" on the activist's efforts.¹⁶⁶ Certainly from a current regulatory perspective, the

¹⁶¹ See Securities Exchange Act § 16, 15 U.S.C. § 78p (2000 & Supp. III 2003); 17 C.F.R. §§ 240.16a-1 to .16c-4 (2006); PETER J. ROMEO & ALAN L. DYE, SECTION 16 TREATISE AND REPORTING GUIDE § 3.03 (2d ed. 2004) (subsection entitled "Derivative Securities"). The SEC has summarized its approach to disclosing derivative positions under Section 16 as follows: "The Commission agrees . . . that any manner of reporting an equity swap, or an instrument with similar characteristics, that provides an adequate description is appropriate." Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 37,260, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. ¶ 85,810, at Part IV.H (May 31, 1996).

¹⁶² See *supra* note 101. Only twelve activists in the study owned over ten percent of their target companies.

¹⁶³ See *supra* text at note 101.

¹⁶⁴ See John Pound, *Proxy Contests and the Efficiency of Shareholder Oversight*, 20 J. FIN. ECON. 237, 260 (1988) (empirical confirmation of the commonsense proposition that in a proxy contest "[d]issident chances are significantly increased by . . . higher dissident holdings").

¹⁶⁵ See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 402 (1983) (observing that "[t]hose who have more shares . . . do not face the collective action problem to the same extent" as those with fewer shares).

¹⁶⁶ Black, *supra* note 140, at 821 (1992). See also George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 903-04

Williams Act and the SEC's implementing Schedule 13D rules take the view that shareholders with less than a five percent stake pose so little threat to corporate management and independence that they are simply not worth bothering with.¹⁶⁷ This Article's comprehensive survey of publicly disclosed activism in 2005 and 2006 has found little or nothing to gainsay this judgment.

C. Reforming the Adverse Position Disclosure Rules

So what needs to be fixed? It would be easy to conclude from the preceding examination of hedge fund activism problems and the related proxy and Schedule 13D disclosure rules that hardly anything needs fixing. But experienced lawyers will have already detected some straining. The current rules work not because of their fundamentally sound design or elegantly crafted line-item requirements. They work because of the general antifraud rules and the well-founded fear of proxy statement and Schedule 13D drafters that leaving out something important (though not directly called for by the line items) would be a very bad idea. A far better approach would be to fix the line items of the rules so that they work well on their own.

Proxy statements and Rule 14a-12 filings both require the same participant ownership information and present the easiest case. Any activist engaged in a "solicitation" is subject their requirements and, as explained earlier, the SEC and the courts define and apply this term more than a bit overbroadly.¹⁶⁸ The real question then becomes how to fix the current rule's outdated reference only to beneficial ownership of company securities, that is, to securities over which the participant has voting or dispositive control.¹⁶⁹ The problems empirically observed in Part III.A above and the

(arguing that high proxy contest expenses exacerbate collective action problems); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 13 (1991) (because a large shareholder "could capture a [larger portion] of the gains, the large shareholder would often have the incentive to act, an incentive [smaller] fragmented shareholders lack").

¹⁶⁷ See, e.g., Filing and Disclosure Requirements Relating to Beneficial Ownership, Securities Act Release No. 5925, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,571, at 80,300 (Apr. 21, 1978) (adopting release for the current rules) (reviewing the legislative and regulatory history of the Williams Act and noting that the statute and rules are directed at "rapid accumulations of . . . equity securities in the hands of persons who would then have the potential to change or influence control" of a public company); Comment, *Section 13(d) and Disclosure of Corporate Equity Ownership*, 119 U. PA. L. REV. 853 (1971) (Williams Act legislative history).

¹⁶⁸ See *supra* text at notes 22-24 and 50-55.

¹⁶⁹ See 17 C.F.R. §§ 240.13d-3 & .14a-101, Item 5(b)(1) (2006).

section 16 derivatives disclosure rules described in Part III.B above then provide the six-part answer: First, section 16's well-known, well-worked-out and encyclopedically comprehensive derivatives disclosure regime also should apply to proxy filings.¹⁷⁰ Second, short as well as long positions should be disclosed. Third, the rule should explicitly confirm that it covers all debt or other obligations or any other item in the company's capital structure, even those that might not technically constitute a "security." Fourth, the entirety of the rule should reciprocally apply to ownership with respect to any actual or known would-be merger or other extraordinary transaction counterparty. Fifth, the rule should have a catch-all like Schedule 13D's reference to "[a]ny [item] similar to those enumerated above."¹⁷¹ And sixth, the rule should require a plain statement of the practical effect of the positions disclosed, such as to establish a hedge, to buy votes, or to create an incentive to support or oppose a proposed transaction requiring a shareholder vote. Taken together, all these changes should clarify the rule's application considerably without altering anything fundamentally.

Schedule 13D disclosure actually presents two separate issues, who files and what gets disclosed. Since this Article has found nothing so wrong with the five-percent filing threshold as to require fixing, the first issue reduces to how to perform the percentage calculation. And here there would appear to be but one sensible answer: include derivatives. A hedge fund, for example, that held 3% of a company's shares "in prime broker" (that is outright) and 3% "in swap" (that is an economic interest held through a derivatives contract) would thus find itself captured by the reporting system. In this day and age there really is not much of an excuse for any lesser approach.¹⁷²

Once a Schedule 13D is required, the simplest and most consistent reform would be to incorporate the proxy rules changes just described. The risk, however, is that doing so might create a horrific and unnecessarily tangled mess out of many otherwise plain vanilla filings. Or stated differently, not every Schedule 13D represents a potential instance of inadequately disclosed "hedge fund activism" run amok. There probably is no easy answer. Perhaps the most direct, albeit highly imperfect solution might be to add an "if material" qualifier to the new disclosure requirements, and to provide a safe-harbor list of situations deemed

¹⁷⁰ See *supra* note 161.

¹⁷¹ See 17 C.F.R. § 240.13d-101, Item 4(j) (2006).

¹⁷² See, e.g., Hu & Black, *supra* note 27, at 867-71 (subsection entitled "Large Shareholder Disclosure") (recommending this approach after extensive analysis).

immaterial. There would be no reason, for example, to require disclosure of positions completely extraneous to the “purpose” of the investment as specifically set forth in the Schedule. Perhaps the best that can be said of the details here is that they would no doubt benefit mightily from the notice-and-comment rulemaking process.

IV. BALANCE OF POWER POLITICS AND CORPORATE GOVERNANCE

Plainly hedge fund activists have a role to play in corporate governance. This Article has shown that *when they choose to get involved*, hedge funds can be a real force to be reckoned with. The question then becomes how they fit into current corporate governance theories and, more practically, whether they improve governance or worsen it. The answer requires a look at hedge funds both as shareholders without more and (assuming proxy contest or settlement success) as shareholders with direct board representation.

A. Why Hedge Fund Activism Matters

But given how infrequently this Article has found that hedge funds do get *directly* involved, there is an obvious threshold question: why should we care about this answer or, put differently, does hedge fund activism matter? Whatever else might be uncertain in our post-Enron world, there would appear to be little room for doubt on this point: we should care about hedge fund activism because the people who run and advise United States public companies care. In other words, those most directly affected by takeovers and proxy fights tell us we should care.¹⁷³ According to Martin Lipton’s recent advice to his clients, for example, “[t]he current high level of hedge fund activism warrants the same kind of preparation as for a hostile takeover bid.”¹⁷⁴ The press reports reviewed in the Introduction tell the same story, albeit in somewhat over-wrought terms.¹⁷⁵ Delaware Chancellor Leo Strine has similarly noted “the power of a good example” and predicted that “[r]emoving a few poorly performing boards will have

¹⁷³ See *infra* notes 186-87 and accompanying text. An interesting recent twenty-year study has found that “there is less need for takeover-related discipline to be applied to target firms when a higher level of monitoring is already in place, as indicated by a higher proportion of outside directors and/or greater [shareholder] blockholdings.” Omeshi Kini, William Kracaw & Shehzad Mian, *The Nature of Discipline by Corporate Takeovers*, 59 J. FIN. 1511, 1512 (2004).

¹⁷⁴ Martin Lipton, *Attacks By Activist Hedge Funds*, M&A LAW., May 2006, at 1 (providing clients with a “Hedge Fund Attack Response Checklist”).

¹⁷⁵ See *supra* text at notes 3-12. For a fairly typical example of hedge-fund hype, see *Battling for Corporate America* from the normally staid ECONOMIST, *supra* note 5, at 69 (calling activist hedge funds “rampaging shareholders”).

substantial, beneficial ripple effects on the performance of other boards.”¹⁷⁶ Evidently the increasingly frequent number of publicly reported instances of direct hedge fund activism is having a still broader, more important *in terrorem* effect on an indeterminately wider universe of public companies.

Many successful hedge fund activism negotiations and settlements also happen behind the scenes with little or no publicity.¹⁷⁷ It is still true, as Michael Useem wrote a decade ago, that “[o]pen struggles for control draw attention but also mislead . . . [because] most of the traffic between managers and investors transpir[es] out of sight.”¹⁷⁸ This kind of quiet activism can be thought of as a kind of Napoleonic military campaign. It is not only the actual battles you fight that count.¹⁷⁹ Real battles cost casualties and money. Battles that the other side can be made to think you are ready to fight matter just as much. Since unfought battles are much cheaper than real ones, you can fight more of them with the same expenditure of scarce manpower, time and money. And quiet, unpublicized shareholder settlement victories count as victories nonetheless.¹⁸⁰

Empirical and other academic studies that review only “proxy fights” while excluding pressure campaigns and most contest settlements miss this considerably larger universe of shareholder activism entirely and consequently unintentionally understate its significance.¹⁸¹ In 2005, for

¹⁷⁶ Strine, *supra* note 15, at 1768.

¹⁷⁷ See Pound, *Political Model*, *supra* note 19, at 1056-57 (observing that private negotiations “provide the most efficient and effective starting point for influencing the policies of incumbents”).

¹⁷⁸ MICHAEL USEEM, *INVESTOR CAPITALISM* 169 (1996).

¹⁷⁹ See CARL VON CLAUSEWITZ, *ON WAR* 212 (Michael Howard & Peter Paret eds. & trans. 1976) (1832) (subsection entitled “Possible Engagements Are To Be Regarded As Real Ones Because of Their Consequences”); see also DAVID G. CHANDLER, *THE CAMPAIGNS OF NAPOLEON* 163 (1966) (observing that Napoleon “was always eager to gain total victory for a minimum of expenditure of manpower and effort” and so consequently “disliked having to force a full-scale . . . frontal battle,” which was “inevitably expensive”).

¹⁸⁰ See Reid Pearson & Ken Altman, *Hedge Funds and Shareholder Activism*, *CORP. GOVERNANCE ADVISOR*, May-June 2006, at 22 (“Whether the company settles with the fund or the fund wins during a proxy fight, hedge funds are having their demands met.”); cf. Bebchuk, *Increasing Shareholder Power*, *supra* note 13, at 878 (arguing that increasing shareholder power “would produce its benefits in large part by influencing management’s behavior rather than by leading to actual interventions,” *i.e.*, voting contests).

¹⁸¹ See, e.g., Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, (SSRN Working Papers, Oct. 2005), <http://ssrn.com/abstract=829804> (relying on Georgeson Shareholder data, which exclude all non-contests and contests settled before mailing, *i.e.*, most settled contests); David Ikenberry & Joseph Lakonishok, *Corporate Governance through the Proxy Contest: Evidence and Implications*, 66 *J. BUS.* 405 (1993) (study excluded settled contests as well as target companies that were not still public and independent five years later).

example, only ten of the situations in this Article's survey count as tracked "proxy fights" in the widely-used Georgeson Shareholder *Annual Corporate Governance Review* data.¹⁸² Acquiring a better understanding of hedge fund activism means probing deeper into publicly reported hedge fund campaigns – something this Article has taken a first step towards doing – though even then quiet settlements, private negotiations and some less-reported situations are inevitably missed.¹⁸³ It only remains certain that hedge fund activism plays a far more important role in corporate governance than a simple look at the raw numbers would first suggest.

B. Activist Hedge Funds As Shareholders

Taking the reality of all this hedge fund activism and trying to fit it into the various corporate governance theories that have been worked out over the years makes for an interesting exercise. Nothing quite fits.

1. Ownership and Control

As with almost all exercises such as this one, the starting point is with the 1932 classic by Adolf Berle and Gardner Means, *The Modern Corporation and Private Property*,¹⁸⁴ which first clearly articulated and popularized the notion that widely dispersed shareholdings had effectively separated ownership from control in public corporations. "Under such conditions," they wrote, "control may be held by the directors or titular managers who can employ the proxy machinery to become a self-perpetuating body, even though as a group they own but a small fraction of the stock outstanding."¹⁸⁵ By the mid 1970s, the principal concern had become how shareholders (the owners) could control and monitor their agents (the directors and managers) while minimizing the "monitoring costs designed to limit the aberrant activities of the agent[s]."¹⁸⁶ Such activities

¹⁸² See Georgeson Shareholder, *supra* note 18, at 44 (list of tracked contests).

¹⁸³ See *supra* Part II.A.

¹⁸⁴ ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1st ed. 1932).

¹⁸⁵ *Id.* at 5-6.

¹⁸⁶ See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 305 (1976), reprinted in *FOUNDATIONS OF CORPORATE LAW* 7, 7 (Roberta Romano ed. 1993). See also Symposium, *Corporations and Private Property*, 26 J.L. & ECON. 235 (1983). Many of the papers in this symposium on the Berle and Means book continue to be cited frequently, including Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 313-14 (1983) (commenting that "the takeover market provides an external court of last resort for protection" of stockholders).

might include almost any imaginable unremunerative sin, including shirking, chasing after perquisites, empire building, and host of other “rent seeking” crimes. An influential group of scholars writing in this tradition came to see the corporation as a “nexus” or “complex set of explicit and implicit contracts” among employees, managers and other constituencies, with the shareholders getting “votes rather than explicit promises.” According to the theory, “[v]otes make it possible to replace the managers.”¹⁸⁷

This is where the problems begin. What does it mean to “vote” and “monitor” when, by hypothesis, shareholders are too dispersed and beset by the collective action problems discussed earlier¹⁸⁸ really to do either? If they were somehow to overcome these problems enough to monitor closely, at what point do they start usurping the management role? And what qualifies them to manage better than the managers themselves anyway? Are board members really mere agents?

2. Shareholder Primacy

The predominant theoretical response to these and other related questions has come to be called “shareholder primacy,” and means basically what the name implies. Shareholders should have the “ultimate control over the corporation.”¹⁸⁹ Since this demonstrably happens only rarely in the actual everyday world of uncontrolled public companies, two of the main avenues of academic inquiry have been why not and how to fix it. The reasons why not are extraordinarily complex, but basically boil down to the collective action problems already mentioned,¹⁹⁰ insufficient incentives,¹⁹¹

¹⁸⁷ Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418, 1421 (1989). See also Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CINN. L. REV. 347, 348 (1991) (“The most immediate concern is whether shareholders can use their power to change the composition of the board of directors through the election process, thus to monitor corporate activity more closely.”).

¹⁸⁸ See *supra* text at notes 163-67.

¹⁸⁹ See Eisenberg, *supra* note 13, at 832; Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 441 (2001) (claiming that shareholder primacy has become the “consensus” view and that other views have been vanquished); Adam Winkler, *Corporate Law or the Law of Business?: Stakeholders and Corporate Governance at the End of History*, LAW & CONTEMP. PROBS, Autumn 2004, at 109 (presenting a progressive criticism of shareholder primacy).

¹⁹⁰ See *supra*, text at notes 165-66.

¹⁹¹ See, e.g., Sanjai Bhagat, Bernard Black & Margaret Blair, *Relational Investing and Firm Performance*, 27 J. FIN. RES. 1 (2004); Roberta Romano, *Less Is More: Making Shareholder Activism a Valued Mechanism of Corporate Governance*, 18 YALE J. REG. 174 (2001). See generally John E. Core, Wayne R. Guay & Tjomme O. Rusticus, *Does Weak*

conflicts of interest,¹⁹² legal obstacles¹⁹³ and management power.¹⁹⁴ Institutional investors consequently generally remain unwilling to spend the time and money to exercise their voting rights fully, that is, to launch proxy fights for control. There is no easy fix. The SEC has proposed letting shareholders put their own director nominees on the official company proxy card at the company's expense;¹⁹⁵ Lucian Bebchuk has taken this one step further and proposed an almost California-like initiative-and-referendum voting procedure that would give shareholders a direct voice in major "rules-of-the-game" decisions currently controlled by boards of directors.¹⁹⁶ The object in any event is to help shareholders exercise in practice their power in theory.¹⁹⁷

For a hedge fund activist, much of shareholder primacy doctrine is already irrelevant or worse, and its fundamental premise that ownership is separated from control seems at best only imperfectly true when it matters most – when the fund is actively investing. A hedge fund that steps in to call the shots at one of its public portfolio companies eliminates the separation and pulls the levers of corporate power directly. By winning board seats, the fund has succeeded in making its voting franchise effective. And as George Dent put it several years ago, an "effective shareholder franchise . . . remed[ies] the separation of ownership and control and, with it, most other corporate governance problems."¹⁹⁸ Throwing out an incumbent board refutes the "separation" thesis: control rejoins ownership.

Governance Cause Weak Stock Returns?, 61 J. FIN. 655 (2006) (finding no empirical support for the hypothesis that weak governance causes weak stock performance).

¹⁹² See Anabtawi, *supra* note 14; Camara, *supra* note 1.

¹⁹³ See Black, *Shareholder Passivity*, *supra* note 2, at 530-66 (comprehensive summary); John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837 (1994).

¹⁹⁴ See Black, *Shareholder Passivity*, *supra* note 2, at 591-95.

¹⁹⁵ See *Security Holder Director Nominations*, 68 Fed. Reg. 60,784 (Oct. 23, 2003) (evidently this proposal is now dead); Bebchuk, *Shareholder Access*, *supra* note 13 (arguing in favor of the proposed rule).

¹⁹⁶ See Bebchuk, *Letting Shareholders Set the Rules*, *supra* note 13, at 844.

¹⁹⁷ See Easterbrook & Fischel, *supra* note 165 at 396 (criticizing and summarizing this approach as "[t]hings will get better if we step up the efforts to attain real corporate democracy").

¹⁹⁸ See Dent, *supra* note 166, at 882; see also George Dent, *Comment: The Case for Real Shareholder Democracy*, 55 CASE W. RES. L. REV. 581 (2005) (reprising proposal that the ten or twenty largest shareholders should select a company's official slate of director nominees); George W. Dent, Jr., *Corporate Governance: Still Broke, No Fix in Sight*, 31 J. CORP. L. 39, 67-75 (2005) (same).

Shareholders willing to wage a proxy fight for control are by definition not fundamentally deterred by any of the problems with the current proxy and corporate rules that supposedly need fixing. Otherwise they would not be activists. Specifically, they have enough shares not to be stymied by the collective action conundrum, their holdings are sufficiently concentrated and undiversified to provide an incentive to act in a chosen instance, they do not have trouble attracting like-minded and unconflicted hedge-fund and other allies, they are more than willing to pay expensive lawyers to dodge the legal obstacles, and they care as much about management's power to stop them as General von Rundstedt did about the Maginot Line in the Spring of 1940.¹⁹⁹ To repeat, otherwise they would not be activists. Proxy fights cost money, and hedge fund activists can and do pay the price.

Other shareholders are not as willing to pay. As for the shareholder primacists' proposed solutions to this problem, these are downright toxic to hedge funds. The main issue is that recently proposed solutions amount to a subsidy for these other shareholders who either cannot or will not pay their own way and, as Roberto Romano recently observed in a related context, "[i]t is textbook economics that parties bearing the full cost of their actions make better decisions than those that do not."²⁰⁰ For a real-life illustration of this point, we have only to look at who uses the SEC's current shareholder proposal rule. Rule 14a-8 lets basically anyone with only \$2000 worth of stock run a 500-word proposal for free in the company's proxy statement.²⁰¹ It is not hard to guess what has happened. The rule has been hijacked by those with agendas other than the merely economic: in 2005, for example, more than half (54%) the governance proposals came from labor unions, religious organizations and public pension funds; and another 22% came from individual investors having ten or more proposals, or in other words professional gadflies.²⁰² An earlier study of the shareholder proposal process reviewed similar statistics and concluded that "nontraditional" sponsors such as these appear "more interested in using the proxy device as a communication or bargaining tool, rather than maximizing

¹⁹⁹ See *supra* Part II; see also Robert C. Pozen, *To Regulate or Not?*, WALL ST. J., June 20, 2005, at A14 ("With their holdings concentrated in a few stocks, hedge funds often have more financial incentive . . . [for aggressive activism] than mutual funds or pension plans with broadly diversified portfolios.").

²⁰⁰ Romano, *supra* note 191, at 230.

²⁰¹ See Rule 14a-8, 17 C.F.R. § 240.14a-8 (2006).

²⁰² See Georgeson Shareholder, *supra* note 18, at 11, 34-37 (detailed figures and tables).

shareholder welfare.”²⁰³ Detailed studies of union and public pension fund activism have reached the same conclusion.²⁰⁴ No matter what the outcome of the actual votes on these proposals, and even if we assume that shareholders have gotten pretty good at separating the value-enhancing wheat from the social-agenda chaff,²⁰⁵ the whole to-do nevertheless remains a significant waste of time and money. Subsidizing these kinds of non-economic agendas does not seem like the most value maximizing policy imaginable.

Hedge funds would in any event likely not qualify to receive the subsidy. Any politically palatable consolidated directors’ ballot, including the one that the SEC has proposed, would likely limit access strictly to long-term, passive holders.²⁰⁶ Hedge fund activists are never passive and are frequently short-term to boot. Similarly, Bebchuk’s initiative-and-referendum proposal would merely empower other large institutional shareholders whose competence, conflict-free judgment and frequently overtly political or at least non-economic goals may be highly suspect.²⁰⁷ In short, empowering these kinds of other shareholders would inevitably bring unwanted and distrusted competition to the corporate governance table. Hedge fund activists therefore paradoxically practice shareholder primacy but cannot believe in it as an academic theory.

3. Director Primacy

²⁰³ See Stephen Choi, *Proxy Issue Proposals: Impact of the 1992 SEC Proxy Reforms*, 16 J.L., ECON. & ORG. 233, 266 (2000).

²⁰⁴ See Romano, *supra* note 191, at 231 (“It is quite probable that private benefits accrue to some investors from sponsoring at least some shareholder proposals. The disparity in identity of sponsors – the predominance of public and union funds . . . – is strongly suggestive of their presence.”); Stewart J. Schwab & Randall Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1023 (1998) (“[W]e suspect that the goal behind some of the union-shareholder activity is to become more involved in strategic decisions Shareholder activism is a promising way of getting the attention of top management and the board of directors.”). See also Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 796 (1993) (noting the vulnerability of public pension funds to “local considerations, such as fostering in-state employment, which are not aimed at maximizing the value of their portfolios’ assets”).

²⁰⁵ See Bebchuk, *Letting Shareholders Set the Rules*, *supra* note 13, at 1799-1804 (arguing that shareholders generally know the right proposals to vote for).

²⁰⁶ See *Security Holder Director Nominations*, *supra* note 195, at 60,805-06 (restricting access to two-year “passive” holders).

²⁰⁷ See, e.g., Anabtawi, *supra* note 14; Camara, *supra* note 1; ISS, *2005 Postseason Report*, *supra* note 75, at 35-49 (detailing labor and “socially responsible investment” priorities and results).

The opposite of shareholder primacy is “director primacy,” a theory championed by Stephen Bainbridge and others.²⁰⁸ According to Bainbridge, this approach remains grounded in the fundamental “nexus of contracts” model, but treats the corporation as something the board of directors uses to hire “various factors of production.”²⁰⁹ The directors do and should run the show by fiat as “a sort of Platonic guardian.”²¹⁰ Shareholders at most react to what the board proposes. Director primacy recognizes this shareholder weakness and actually welcomes it: their weakness contributes to director power, which in turn leads to efficient decision-making and greater shareholder wealth.²¹¹ Director primacy very much draws the line between authority and accountability in favor of authority.²¹² The shareholders’ right to throw out an incumbent board thus remains only as “an accountability device of last resort.”²¹³

Hedge fund activists fit into the director primacy paradigm as paradoxically as they did into shareholder primacy. They must believe in director primacy as an academic theory, but they do not practice it. They have to believe in it as a theory for three reasons. First, boards actually do run most corporations,²¹⁴ and any theory that accurately explains reality automatically has some considerable claim to validity. Second, having a strong board in charge is always efficient²¹⁵ and usually satisfactory to the shareholders in the sense that activists leave most public companies alone. Third and most important, director primacy provides a theoretical framework for justifying the exclusion of the wider “shareholder activism” community, the big institutions of even bigger possible economic untrustworthiness.²¹⁶ What self-respecting hedge fund, for example, would brook for an instant the non-economic and personal agendas often pursued

²⁰⁸ See, e.g., Bainbridge, *Means and Ends*, *supra* note 14.

²⁰⁹ *Id.* at 550.

²¹⁰ *Id.* At 550-51.

²¹¹ See Bainbridge, *Shareholder Disempowerment*, *supra* note 14, at 1735.

²¹² See Bainbridge, *Director Primacy*, *supra* note 14, at 605.

²¹³ See Bainbridge, *Shareholder Disempowerment*, *supra* note 14, at 1750.

²¹⁴ See, e.g., DEL. CODE ANN. tit. 8, § 141 (2001) (requiring the “business and affairs of every corporation” to be “managed by or under the direction of a board of directors”); Sparks, *supra* note 15, at 21 & n.8 (collecting cases).

²¹⁵ See Strine, *supra* note 15, at 1762-64.

²¹⁶ See *supra* note 192 and accompanying text.

by so many public pension funds and unions?²¹⁷

When it comes to actual practice, however, things are very different. Unless an activist hedge fund itself controls a board of directors, it cannot believe in director primacy. Otherwise it would not have become a shareholder activist and would not be trying either to tell the current directors what to do or to replace them outright. For a hedge fund, the shareholders' right to replace directors is anything but an "accountability device of last resort."

A glance at the "principal issues" and "result" columns in the Appendix reveals what this actually means. In almost every case, the hedge funds in the study focused on direct economic issues such as blocking or forcing a corporate sale or otherwise enhancing value with a stock buy-back, asset sale or other similar effort. Apart from the "end game" corporate sale issue, which would require a shareholder vote in any event, much of this kind of activity necessarily involves assuming a degree of operational control that is fundamentally inconsistent with director primacy. Setting a dividend rate or determining how many shares to repurchase are matters not normally entrusted to the shareholders. Conversely, purely corporate governance issues seem to take a back seat to the economic issues. Destaggering a board of directors, for example, has hedge-fund meaning only to the extent that it leads directly to enhanced economic performance for the fund. Like many academics,²¹⁸ hedge fund managers evidently remain unconvinced or agnostic on how directly corporate governance issues correlate with economic profitability and higher stock prices.

An important variant of the director primacy theme, the "team production" theory, similarly places the board of directors at the center of corporate power.²¹⁹ Under this theory, the board acts as a trusted referee or "mediating hierarch" holding sway over all the different team members that contribute to corporate success. Shareholder voting generally plays no role at all except as "a safety net to protect against extreme misconduct."²²⁰ But a hedge fund concerned with enhancing value through a stock buy-back or with gaining board seats to run a company more profitably is hardly

²¹⁷ See *supra* note 204 and accompanying text. See also Chris Young, *Hedge Funds to the Rescue*, BUS. WK., July 31, 2006, at 86 ("[L]eft-leaning pension funds have long taken activist stands on pet peeves such as golden parachutes or the labor impact of a proposed deal. Hedge funds, however, maintain a laser focus on shareholder value.").

²¹⁸ See *supra* note 191 and accompanying text.

²¹⁹ See Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999). See also Symposium, *Team Production in Business Organizations*, 24 J. CORP. L. 743 (1999).

²²⁰ See Blair & Stout, *supra* note 219, at 312.

concerned with “extreme misconduct,” or even any misconduct at all. The company’s board of directors might be doing a simply okay job where the hedge fund might believe that a real home run might be possible if only it could step into the batter’s box itself.²²¹ The originators of the team production theory, Margaret Blair and Lynn Stout, forthrightly admit that their theory does not really work well here, but argue that real shareholder activism and voting does not figure into how most public companies operate most of the time.²²² The findings of the present Article, however, suggest that hedge fund activists have significantly undermined unfettered director power at more than just a few companies, and much of director primacy theory along with it.

Blair and Stout do not stop here. They intriguingly suggest in the conclusion of their path-breaking article that their approach reveals the “fundamentally political nature of the corporation,” and that future scholarship should look into how shareholders and other corporate constituencies use “political tools, in addition to economic and legal tools” to try to capture a larger share of firm profits.²²³ Much of the present Article attempts just such an examination of the most active shareholders, namely hedge funds.

4. Balance-of-Power Politics

Evidently none of these theories really fits what activist hedge funds do, which brings us to naked balance-of-power politics as perhaps the most accurate way of thinking about how they actually operate. For them, corporate governance seems most like a kind of war with a putatively failing, slothful or simply ineffective board of directors as the enemy.

The best starting point here might be the almost nihilistic “connected contracts” metaphor outlined a few years ago by three professors at UCLA.²²⁴ According to this approach, the “interrelated agreements” among the participants in a business are little more than ad hoc arrangements: “there are no firms, no predetermined hierarchies, no organizations . . . and no a priori notions of ownership or control; there is no shareholder or

²²¹ See, e.g., Kerr McGee Corp., Schedule 13D filed by Icahn (Mar. 3, 2005) (start of proxy fight to elect directors who will sell assets and reallocate corporate resources to a stock buy-back).

²²² See Blair & Stout, *supra* note 219, at 309-315.

²²³ See Blair & Stout, *supra* note 219, at 323.

²²⁴ See G. Mitu Gulati, William A. Klein & Eric M. Zolt, *Connected Contracts*, 47 UCLA L. REV. 887 (2000).

managerial primacy and no centralizing ‘nexus.’”²²⁵ In a word, “there is nothing to govern.”²²⁶ For a public shareholder, what inevitably ensues is a sort of virtually formless political free-for-all essentially devoid of theoretical principles. But this is not necessarily bad. “[I]nsurgency, contention, and debate are fundamental to effective corporate governance,” as John Pound once put it in the conclusion to his aptly titled article *The Rise of the Political Model of Corporate Governance and Corporate Control*.²²⁷

This is really little more than the raw balance-of-power politics familiar to any historian of eighteenth century Europe. According to one classic text, statesmen of that era confronted “an anarchic . . . society in which expansion was left free until it was checked by conflicting ambitions, expressed in terms of the balance of power.”²²⁸ This principle, in turn, was found more useful than international law, which was then “nothing more than a war code.”²²⁹ Translated into the language of hedge fund activism, this means that proxy fights and the threat of proxy fights operate far more efficiently to exercise control over directors than the purely legal alternatives – occasionally ephemeral fiduciary-duty legal principles and the vagaries of the market for corporate control.²³⁰

Reliance on fiduciary-duty principles is misplaced because they are so limited. Duty of loyalty compliance usually requires little more than honesty in fact and a high tolerance for putting up with independent-committee board procedures.²³¹ Duty of care compliance requires even less. Ordinary workaday director decisions are almost always protected by the business judgment rule, which amounts to a standard of gross negligence.²³² The courts accordingly hardly second-guess any director decisions at all.²³³

²²⁵ *Id.* at 887.

²²⁶ *Id.*

²²⁷ Pound, *Political Model*, *supra* note 19, at 1071.

²²⁸ WALTER L. DORN, *COMPETITION FOR EMPIRE, 1740-1763*, at 2 (1940).

²²⁹ *Id.*

²³⁰ See Larry Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 NOTRE DAME L. REV., at Introduction (forthcoming 2006) (noting the three mechanisms for controlling director power, “shareholder voting, fiduciary duties and the market for corporate control”).

²³¹ See *infra* text at notes 243-45.

²³² See, e.g., *In re Walt Disney Co. Derivative Litig.*, No. 15,452, slip op. at Part IV.A.1 (Del. June 8, 2006); *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985) (leading case).

²³³ See E. Norman Veasey, *What Happened in Delaware Corporate Law and Governance From 1992-2004?*, 153 U. PA. L. REV. 1399, 1405 (2005) (noting that “[c]ourts

Reliance on the disciplining effect of takeovers is equally misplaced. Apart from regulatory problems and a host of other issues including sheer size, legal devices such as staggered boards and poison pills can make many companies practically takeover-proof.²³⁴ Like international law in the Eighteenth Century, fiduciary-duty principles and the supposedly disciplining effect of takeovers appear less than completely satisfactory instruments of shareholder defense and control.

Yet another paradox lurks here. As noted in the Introduction, many in the corporate community believe that the corporate governance status quo remains fundamentally sound.²³⁵ According to Martin Lipton and Steven Rosenblum, the present system “has developed over many years . . . through an ongoing process of experimentation and experience,” and already makes “running an election contest through separate proxy materials . . . a viable alternative.”²³⁶ Gilcrest Sparks, a dean of the Delaware corporate bar, has similarly observed that the current director-centered system appears “robust,” and that the possibility of running a stand-alone proxy contest against an incumbent board is “becoming more rather than less real,” thanks in part to “the dramatic increase in focused capital available in the hands of hedge funds.”²³⁷ This self-satisfied rhetoric is not altogether empty. Hedge funds are rarely mistaken for status quo apologists, but (paradoxically) this is evidently what they believe, too, or else they would not act the way they do. In the hands of a well-financed activist such as a hedge fund, proxy fights make a viable and useful corporate governance tool.

At least in Delaware, takeover defenses generally do not work against

should not second-guess the business decisions of directors, and the Delaware courts have not done so”). See generally Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55 (1991) (weak effectiveness of shareholder litigation as a governance monitoring device).

²³⁴ See Lucian A. Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory Evidence, and Policy*, 54 STAN. L. REV. 887, 914, 928 (2002) (finding that no hostile takeover “in recent memory” has ever succeeded against a company with both a poison pill and a staggered board of directors); Holman W. Jenkins, Jr., *Don’t Sweat It: There’s Nothing Wrong with Corporate Governance That the Threat of a Hostile Takeover Couldn’t Fix*, WALL ST. J., Feb. 24, 2003, at R8 (lamenting the post-pill weakness of the “market for corporate control,” noting that an “important negative check on management went missing when we reined in hostile takeovers,” and arguing for unspecified legal reforms to return the “bracing possibility” of hostile attacks to improve corporate governance).

²³⁵ See *supra* text at notes 15-16.

²³⁶ Lipton & Rosenblum, *supra* note 15, at 69, 93.

²³⁷ Sparks, *supra* note 15, at 22. Chancellor Strine also appears to believe in the “balance” between director and shareholder power in the current “American – that is, the Delaware – approach to corporation law.” Strine, *supra* note 15, at 1762, 1767.

proxy fights.²³⁸ For a hedge fund activist, an actual or threatened proxy fight is therefore direct, efficient, and as ultimately determinative as one of Napoleon's battles. Beyond this, theory really does not enter much into it.

C. Activist Hedge Funds With Board Representation

Of course the entire approach changes if an activist fund succeeds in gaining direct board representation, thus joining the "team." At this point the rules of the game shift, sometimes for the worse. This is especially true when a fund achieves only minority board representation, such as when a company's board is staggered so that all directors are not up for election every year, when the tactical choice is made to run a short slate or when a negotiated settlement is but partially successful.

No matter what the situation, the federal securities laws effectively mandate that any hedge fund with direct board representation become a long-term investor. Such a fund will likely be considered a presumptive "affiliate" sharing in company control, and so consequently will not be able to sell shares freely in the market until some indeterminate time after the board relationship ends.²³⁹ If the fund communicates with its board representatives or anyone else at the company about company affairs, as will often be the case, it will probably also find itself precluded from selling or buying any shares because of the insider trading rules.²⁴⁰ Depending upon the circumstances, there may even be the theoretical or real possibility of short-swing profits disgorgement under Section 16 of the Securities Exchange Act.²⁴¹ All these rules effectively combine to preclude short-term

²³⁸ See *supra* notes 77-81 and accompanying text. Of course, an effective staggered board will prevent a dissident from acquiring a majority of board seats in any single election, and an advance-notice bylaw will constrain a dissident's timing.

²³⁹ See Robert A. Barron, *Control and Restricted Securities*, 20 SEC. REG. L.J. 194, 197 (1992) (summary of Securities Act rules); Robert A. Barron, *Control and Restricted Securities*, 13 SEC. REG. L.J. 72 (1985) (addressing "affiliate" status of directors); Thomas Gilroy & Paul N. Sheridan, *Rule 144*, in 3 SECURITIES LAW TECHNIQUES § 38.01 (A.A. Sommer, Jr., ed. 2005) (same). The facts-and-circumstances based complexities of determining "affiliate" status have led the SEC to stop issuing no-action letters on the topic. See Securities Act Release No. 6253, 1 Fed. Sec. L. Rep. (CCH) ¶ 373 (Oct. 28, 1980). The classic treatment remains A.A. Sommer, Jr., *Who's "In Control"?* – S.E.C., 21 BUS. LAW. 559 (1966).

²⁴⁰ See Exchange Act Rules 10b-5 & 10b5-2, 17 C.F.R. §§ 240.10b-5 & .10b5-2 (2006); Thomas W. Briggs, *Insider Trading and the Prospective Investor After the Chestman Decision*, 20 SEC. REG. L.J. 296 (1992) (review of insider trading rules applying to institutional investors).

²⁴¹ See *supra* text at notes 161-62; ROMEO & DYE, *supra* note 161, at § 2.04 (discussing the "deputization" theory pursuant to which an entity that has a board representative can sometimes itself become subject to the Section 16 profits-disgorgement rule).

trading once one or more board seats are obtained.

State laws concerning director fiduciary duties further constrain an activist fund. Once on the board, even dissident directors elected after a proxy fight owe the complete entirety of their fiduciary obligations to the company as a whole and all its shareholders, not just to the activist that nominated them.²⁴² The fiduciary obligation of loyalty, in particular, cannot be limited or disclaimed, and effectively makes financial hanky-panky with the company impossible, or at least subject to the exacting “entire fairness” standard of judicial scrutiny.²⁴³ This rule can make even otherwise ordinary dealings substantively subject to judicial second-guessing and procedurally difficult to accomplish without cumbersome “independent committee” review and approval.²⁴⁴ The SEC’s rules specifically mandating the disclosure of these kinds of “related party” transactions exacerbate matters by casting perhaps unwanted sunlight into these otherwise dark corners, and recently adopted rules now require disclosure of the company’s transaction approval procedures as well.²⁴⁵ Careful advance planning and detailed consultations with lawyers experienced with these kinds of issues slow decision-making at every turn.

It logically follows that a dissident director’s fiduciary duties extend to any information received as a director, and that all this information must be kept confidential and not misused. In the words of the leading Delaware

²⁴² See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 708-11 (Del. 1983) (leading case); 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* § 4.38[B] (3d ed. 2006) (subsection entitled “Responsibilities of Directors Designated by Majority or Other Large Stockholders”). Roberta Karmel has suggested that nominating shareholders should also have fiduciary duties. See Roberta S. Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Shareholders?*, 60 *BUS. LAW.* 1 (2004).

²⁴³ See *Kahn v. Lynch Comm. Sys. Inc.*, 638 A.2d 1110 (Del. 1994) (independent committee approval shifts the burden of showing entire fairness to the plaintiff). If a shareholder is not considered a “controlling” shareholder under Delaware law, the situation improves somewhat. Full disclosure and approval by the disinterested directors can preserve the protection of the business judgment rule and avoid “entire fairness” review. See *DEL. CODE ANN.* tit. 8, § 144 (2001). See generally 1 NANCY E. BARTON, DENNIS J. BLOCK & STEPHEN A. RADIN, *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* 261-488 (5th ed. 1998 & Supp. 2002).

²⁴⁴ See *supra* note 243.

²⁴⁵ See Executive Compensation and Related Person Disclosure, Securities Act Release No. 8732, 71 *Fed. Reg.* (Aug. 2X, 2006) (amending disclosure requirements for transactions with related parties, including 5% shareholders, and adding disclosure requirement for related-party transaction approval procedures, currently and to be codified at 17 C.F.R. § 229.404, which is implemented in proxy solicitations through Item 7 of Schedule 14A, 17 C.F.R. § 240.101, Item 7 (2006)).

case, if the director “violates that duty, the law provides a remedy.”²⁴⁶ Sometimes corporations even manage to extract an explicit promise that a dissident board member simply will not share anything he learns with his sponsoring fund.²⁴⁷ Monitoring an investment under these kinds of informational constraints can frequently wind up being neither easy nor even particularly efficient or effective.

If a fund has won only minority representation, the problems deepen. The very structure of the board itself can work against the dissident faction. Boards act collegially.²⁴⁸ Indeed, “[c]ommon sense tells us that the constantly carping critic . . . is unlikely to be effective in persuading any group to effective collective action.”²⁴⁹ The dissidents can find themselves ostracized and left out of caucuses where all the real decisions are taken or, in truly extreme cases, excluded from a newly-formed executive committee with de facto plenary authority to run the company without any dissident input at all.²⁵⁰ Alternatively, a weak-willed dissident may succumb to cooption or outright capture.²⁵¹ Sometimes, too, a dissident board faction

²⁴⁶ *Henshaw v. American Cement Corp.*, 252 A.2d 125, 130 (Del. Ch. 1969). *See also* 2 DAVID A. DREXLER, LEWIS S. BLACK, JR. & A. GILCHRIST SPARKS, III, *DELAWARE CORPORATION LAW AND PRACTICE* § 27.05 (2005).

²⁴⁷ *See* Lee Hawkins, Jr. & Joseph B. White, *Kerkorian Aide to Join GM's Board*, WALL ST. J., Feb. 7, 2006, at A3 (describing confidentiality agreement). Boards sometimes also adopt “gag” resolutions prohibiting the sharing of information with outsiders. *See* General Housewares Corp., Current Report (Form 8-K) (May 28, 1999) (resigning director setting forth text of board resolution prohibiting communications with “family, friends or business associates” or company advisors outside the presence of senior management). Because this kind of resolution could interfere with a director’s exercise of his fiduciary duties, there may be circumstances where it might not survive judicial challenge.

²⁴⁸ *See* COLIN B. CARTER & JAY W. LORSCH, *BACK TO THE DRAWING BOARD: DESIGNING CORPORATE BOARDS FOR A COMPLEX WORLD* 174 (2004) (noting that in the boardroom “[g]roup norms can discourage . . . dissent”); Lipton & Rosenblum, *supra* note 15, at 80-83; Martin Lipton, *Some Thoughts for Boards of Directors in 2006*, CORP. GOVERNANCE ADVISOR, Jan.-Feb. 2006, at 1, 4 (“A balkanized board is a dysfunctional board.”).

²⁴⁹ *See* John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board to Meet New Governance Mandates*, 59 BUS. LAW. 421, 448 (2004).

²⁵⁰ *See* Julie Connelly, *Dissenting Directors: Should You Shut Up, Quit, or Fight?*, CORP. BOARD MEMBER, Sept.-Oct. 2002, at 26 (cover story) (noting that dissenters are “isolated so that you’re kept out of the information loop,” and describing formation of board executive committee excluding dissident); Phyllis Plitch, *Breaking the Code of Silence*, WALL ST. J., Apr. 10, 2006, at R4 (describing pressure to conform “at all costs” and what happens to those who do not).

²⁵¹ *See* Arnoud W.A. Boot & Jonathan R. Macey, *Monitoring Corporate Performance: The Role of Objectivity, Proximity and Adaptability in Corporate Governance*, 89 CORNELL L. REV. 356, 358-59 (2004) (arguing that the “proximity” of board participation makes “capture” all but inevitable, and defining “capture” as when a “block shareholder . . . who is the

can simply find itself outvoted.²⁵² One of the funds in the survey went so far as to refuse a proffered board seat because it did not see how, “[a]s one vote among twelve,” it would have “any greater ability to effect change” than as an ordinary outside shareholder.²⁵³

The actual experiences of many dissident directors, however, paint a picture not nearly so bleak. Even one dissident can often be highly effective, especially when it comes to killing unwanted mergers or other initiatives. After settling for just one board seat in his fight with Sovereign Bank, for example, Ralph Whitworth told the *Wall Street Journal*’s “Heard on the Street” column that “[v]ocal dissenters can have outsized influences in clubby corporate boardrooms, essentially exercising veto power over major strategic decisions such as an acquisition.”²⁵⁴ Sometimes the right dissident can wind up assuming board leadership.²⁵⁵ Having a big stake does not hurt, either, and in the right hands can turn into a big stick.²⁵⁶ In fact, one theoretical study has concluded that truly independent directors such as those “who own a large block of shares or are employed by a large shareholder” may actually increase the effectiveness of a board because they are thereby “shielded from . . . ejection” and the consequent need to accede to management’s wishes.²⁵⁷

This brings us to the strangest problem. At least some experienced directors and judges believe that when it comes to board service it helps to have “skin in the game.”²⁵⁸ If recent scandals such as those involving

ostensible monitor adopts the perspective of the management team being supervised”); Dent, *supra* note 166, at 909 (observing that “minority directors usually wind up indistinguishable from the majority”).

²⁵² See Dennis K. Berman & Sarah Ellison, *Tribune Buyback Draws Opposition From Chandlers*, WALL ST. J., June 7, 2006, at A1 (three of eleven directors publicly become dissidents and are outvoted when company goes forward with planned self-tender).

²⁵³ Phelps Dodge Corp., Schedule 13D filed by Atticus Capital (Feb. 15, 2006) (letter to board of directors).

²⁵⁴ David Enrich, *Sovereign, Relational Crusaded Right Up to Their Uneasy Truce*, WALL ST. J., Mar. 24, 2006, at C3.

²⁵⁵ See Carol Hymowitz, *How to Fix a Broken System*, WALL ST. J., Feb. 24, 2003, at R1, R3 (“Even a lone dissenter on a board can exert a big influence”); Seiden, *supra* note 83, at 30 (noting that the right dissident can sometimes assume de facto board leadership).

²⁵⁶ See Connelly, *supra* note 250 (large share ownership means “persuasive muscle” in the boardroom).

²⁵⁷ See Vincent A. Warther, *Board Effectiveness and Board Dissent: A Model of the Board’s Relationship to Management and Shareholders*, 4 J. CORP. FIN. 53, 65 (1998). An “ejected” board member is presumably ostracized, asked to resign or not renominated.

²⁵⁸ See Strine, *supra* note 15, at 1781 (opining that stockholders with “skin in the game” should choose director nominees); Plitch, *supra* note 250, at R4 (quoting dissident director as

Enron, Tyco and WorldCom have taught us that “being willing to challenge company management may be the most crucial qualification for a board seat,”²⁵⁹ and if having a lot of shares helps foster this kind of independence, then why do the SEC’s implementing rules under Sarbanes-Oxley discriminate against board representatives of ten-percent and larger shareholders?²⁶⁰

But despite these problems, many activist hedge funds continue to seek board seats. Unlike some of the larger institutional investors, such as on occasion those associated with governmental entities and unions, they are in business exclusively to make money all the time. They therefore presumably believe that they will make more money with board representation, even minority representation, than without. Otherwise they would not be activists who seek board seats. In theoretical terms, they consequently apparently believe that vertical (meaning corporate officers) and horizontal (meaning the other directors) monitoring and control must be more efficient and effective from within than from without.²⁶¹ And to hear the howls of protest from corporate managements and their lawyers reviewed in the Introduction,²⁶² they are not the only ones to think so.

V. CONCLUSION

At the end, we are inevitably left with a fundamental question: what is the meaning of hedge fund activism? This Article has conducted a legal, empirical, and theoretical study in an effort to develop an answer.

This Article has shown that the SEC opened the door to hedge fund activism when it got out of the proxy material pre-screening and censorship business in 1992 and when it adopted the Regulation MA-related “free communication” Rule 14a-12 in 1999. The recent rise in hedge fund assets, the increasing difficulties fund managers have had in finding ready-made investment opportunities for so much money, and the changes in investor and corporate attitudes following the scandals that led to the passage of the Sarbanes-Oxley Act in 2002 have all combined to lead hedge funds to walk

saying, “[n]o amount of consultants’ reports or peer review studies can substitute for directors who have skin in the game”).

²⁵⁹ See Carol Hymowitz, *How to Be a Good Director*, WALL ST. J., Oct 27, 2003, at R1, R4.

²⁶⁰ See *supra* text at notes 82-85.

²⁶¹ See Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 32-41 (2002) (reviewing agency costs and vertical and horizontal monitoring).

²⁶² See *supra* text at notes 1-5.

through this open door.

This Article's empirical survey of hedge fund activism during 2005 and the 2006 proxy season is notable both for what it found and for what it did not find. In raw numbers, fewer than 50 hedge fund activism situations during this period hardly make hedge funds a *direct* and present threat to corporate America. But the indirect effects appear to be much greater. Armed with Rule 14a-12 and evidently undeterred by the threat of becoming a "group" under the Schedule 13D rules, hedge funds with significant shareholdings have been able to use wolf-pack tactics against companies to achieve at least some of their aims. The ovine willingness of institutional investors to follow the pro-shareholder, pro-activist recommendations of Institutional Shareholder Services and its competitors have helped make these tactics still more effective.

Despite claims that hedge funds are frequently dangerously conflicted, the survey did not find much in the way of a "dark side" to hedge fund activism. With only one notable exception (Perry at Mylan Labs), adverse positions and other conflicts appear to have been fully disclosed in the few instances where they have appeared. Shareholders would seem to have been really put off by the disclosed conflicts only once (Verizon-MCI-Deephaven). Nevertheless, based on the survey, it seems that the proxy and Schedule 13D rules require clarification so that their line-item disclosure requirements directly pick up these potential conflicts.

In any event, what hedge funds actually do does not fit neatly into the "nexus of contracts" and other theories of how shareholders and corporate managements relate to each other. At least one thing is clear. This Article would not exist if hedge funds were the powerless, atomized shareholders of the latter-day Berle and Means theorists or if they were deterred by the well-documented obstacles to a greater shareholder role in corporate governance.

Hedge fund activists paradoxically practice "shareholder primacy" but cannot believe in it as a theory lest it empower the large and frequently conflicted institutional investors such as public pension and union funds sufficiently to allow them to take a competing seat at the corporate governance table. There is also a second paradox. Hedge fund activists must believe in director primacy as an academic theory because it most accurately describes the current state of the real world and because it helps justify keeping these kinds of other institutions as far away from the corporate governance banquet table as possible. But of course as shareholder activists, they do not for a minute believe in "director primacy" as a practical matter. Perhaps the best way of thinking about how hedge fund activists fit into corporate governance today is raw balance-of-power politics with proxy fights taking the place of warfare. Or to phrase it

another way, hedge fund activists appear to have finally effected what John Pound perhaps prematurely predicted over a decade ago: the rise of the political model of corporate governance.

Hedge fund activists apparently continue to believe that direct board representation helps them to achieve greater control over their investments and, presumably, greater profits. On the other side, corporate managements seem to believe that this kind of effective “control” is not at all an unalloyed good.

It is too early to say whether hedge fund activism is profitable for the funds, value-maximizing for other public shareholders, or good for corporate governance in the United States generally. As for the first point, the results so far appear somewhat mixed.²⁶³ As for the second, the survey uncovered substantial shareholder skepticism in just one instance. And as for the third, only time will tell. This Article’s data are too limited for a definitive answer. But this much seems certain: hedge fund activists do sometimes come up with “eminently sensible ideas,”²⁶⁴ and the pressure they bring is forcing managements far beyond those of the few specific companies directly affected to come up with their own good ideas or, in Martin Lipton’s words, to “[r]eview basic strategy . . . in light of possible arguments for spinoffs, share buybacks, special dividends, sale of the company or other structural changes.”²⁶⁵

Hedge fund activists are not “normal” institutional investors. They threaten and even actually launch proxy fights for corporate control. They attack in wolf packs. If this causes managements to reexamine their businesses and “review basic strategy” accordingly, corporate governance has unquestionably been improved.

²⁶³ See, e.g., Joann S. Lublin, *In for the Long Haul*, WALL ST. J., Oct. 17, 2005, at R9 (cautioning that “dissident investors’ enlarged boardroom presence doesn’t always guarantee better times”); Liz Moyer, *High-Impact Activism*, FORBES.COM, Feb. 7, 2006, http://www.Forbes.com/management/2006/02/06/shareholder-activism-redux-x_lm_0207shareholder.html (noting “mixed success” of some fund managers, and quoting ISS official as saying that “we may not be able to render a verdict for a while . . . [b]ut it seems like it has been hit or miss”); Zuckerman, *supra* note 10, at C3 (noting that it is “hard to quantify the returns from activism”).

²⁶⁴ Der Hovanesian, *supra* note 3, at 72.

²⁶⁵ Lipton, *supra* note 174, at 3.

APPENDIX: HEDGE FUND ACTIVISM, JANUARY 2005 - AUGUST 2006

Company	Insurgent	End Date	Principal Issues	Method	Amount Held	Litigation	Result	ISS Advice	Comments
Steven Madden	Barrington Capital	2/2/05	Board seats, governance, sale	13D, 14a-12	7.7%		1 independent board seat, stock buy back		Settled
Circuit City	Highfields Capital	3/7/05	Purchase offer	13D	6.8%		Offer rejected, stock buy back		CEO later resigned
Sears	Lampert	3/25/05	Negotiated sale	Stealth 13G	15.0%	Late 13D (post hoc by holder)	Sale to K-Mart	For merger	Lampert owned 52% of K-Mart
Beverly Enterprises	Appaloosa, Formation	4/11/05	Sale, board seats	13D, 14a-12, mailed	8.1%		Sale, no board seats		Settled; used wolf pack tactics
Kerr-McGee	Icahn	4/14/05	Board seats, enhance value	13D, 14a-12, HSR	7.6%	13D, proxy rules	Buy back, asset sale, no board seat		Settled; company sold in 2006
Blockbuster	Icahn	5/11/05	Board seats, enhance value	13D, 14a-12, full contest	9.7%		3/7 board seats won	Dissidents (2/3)	Board expanded by 1 to put CEO back on board
Cornell Companies	Private Capital	5/19/05	Board seats, sale, enhance value	13D, 14a-12	14.8% + 5% + 7.5%		7/9 board seats		Settled; top 9 holders = 75.7%
BioMarin Pharmaceuticals	OrbiMed Advisors	5/27/05	Board seats, enhance value	13D, 14a-12, mailed, short-slate rule	8.2%		2 board seats + 1 independent		Settled
BKF Capital Group	Steel Partners	6/9/05	Board seats, governance	13D, 14a-12, full contest	9.5%		3 board seats won, destaggered board	Dissidents	Significant economic loss
Mylan Labs	Icahn	7/18/05	Board seats, oppose merger, Icahn offer letter	13D, 14a-12	9.8%	Legality of bylaws, by Icahn	Offer and proxy fight dropped, issuer self-tender		Short in merger counterparty; vote buying
AirNet Systems	Opportunity, Pacific Coast	7/27/05	Board seats, sale	13D, special meeting consent solicitation	13.3%		2 board seats, sale efforts		Settled; delisted from NYSE after sale efforts falter
Cutter & Buck	Private Capital	9/7/05	Board seats, governance	13D	12.5%		Terminated pill, declassified board, no seats		Settled; top 5 holders had 51%
Siebel Systems	Tudor, Jana, Icahn	9/12/05	Sale	13G, Publicity	5.7% + 10% misc. others		Sale		"Heard on the Street" in WSJ
Cenveo	Burton Capital	9/13/05	Board seats, enhance value	13D, 14a-12, mailed	10.7%		7/9 board seats	Dissidents	Settled; called special meeting (had over 10%)
Register.com	Barrington Capital and Mark Cuban	9/15/05	Board seats, sale price	13D, 14a-12	14.9% + 13.7%		\$500k, Barrington joined buyer; Cuban objects		Settled; joint slate without "group" filing
Shopko	John A. Levin & Co.	9/29/05	Sale price	13D, 14a-12	6.0%		\$300k, voting agreement, higher price		Settled; interloper wins company
MCI	Deephaven	10/06/05	Sale price	Proxy statement only, started mailing	4.9%		Lost vote but got higher price	For merger	Owned bonds, stock, swaps, short in others
Computer Horizons	Crescendo	10/11/05	Board seats, oppose merger, sale	13D, 14a-12, full contest	10.3%	Not significant	5/5 board seats won, merger defeated	Management slate, but oppose merger	Bylaws permitted 10% meeting call

Company	Insurgent	End Date	Principal Issues	Method	Amount Held	Litigation	Result	ISS Advice	Comments
Alliance Semi-Conductor	B. Riley & Co.	10/18/05	Board seats, asset sales	13D, 14a-12, mailed	6.9%		4/7 board seats	Dissidents (1/5)	Settled
A. Schulman	Barrington	10/24/05	Board seats, sale	13D, 14a-12	8.7%		Self tender, 1 board seat + 1 independent		Settled
Exar	GWA Investments	11/07/05	Board seats, governance, enhance value	14a-12, full contest	0.7%		3/9 board seats won	Dissidents	"Independence" listing problems after win; GWA was 96% hedged
Knight Ridder	Private Capital	11/14/05	Sale	13D	18.9% + 9% + 8%		Sale		Proxy fight threatened
Six Flags	Red Zone	11/22/05	Board seats, governance, sale	13D, 14a-12 full consent solicitation	11.7%		3/7 board seats won, de facto control	Dissidents	Charter allowed consent; sale process fizzles
Ligand Pharmaceuticals	Third Point	12/5/05	Board seats, maximize value	13D, 14a-12, preliminary proxy	9.9%	Late annual meeting, by Third Point	3/11 board seats; maximize value		Settled; top 9 holders had 63%
Office Max	K Capital Partners	4/27/05 and 12/27/05	Sale, governance, board seat	13D, 14a-12, started mailing	6.2%; then 8.6%		1 independent board seat, de-staggered board		1st year settled; 2nd year unilateral exit
McDonald's	Pershing Square	1/24/06	Enhance value	Publicity	4.9%		Many restaurants to be sold		Low risk, modest success
Bally Total Fitness	Pardus; Liberation	1/26/06	Board seats, governance, enhance value	13D, 14a-12, full contest	14.3% + 12% + 10%	Pill and 13D, state and federal court	3/9 board seats won; company was shopped; CEO fired	Dissident slate	Joint slate with no group filing or Pill trigger; owned debt; 3-way fight
General Motors	Tracinda	2/6/06	Board seat, Enhance value	13D, HSR	9.9%		1 board seat, dividend cut		Settled; big 13D publicity campaign
Phelps Dodge	Atticus	2/15/06	Maximize value	13D	9.9%		None		Refused board seat
Time Warner	Icahn	2/17/06	Board seats, maximize value	13D, 14a-12 (13D filed by Icahn advisee)	5.7%		2 independent directors, larger stock buy-back		Settled; 14a-12 war w/o proxy statement; derivatives issues
Wendy's	Triam Fund	3/3/06	Board seats, enhance value	13D	5.5% + 22% misc. others		3/15 board seats		Settled; white paper; wolf pack tactics; options
Novoste	Steel Partners	3/21/06	Board seats, oppose liquidation	13D, full contest on liq. vote; then prelim. proxy	19.6% + 5.3% + 8.2%		Liquidation defeated; 3/4 seats	Against liquidation; silent on board contest	Board contest settled at prelim. proxy stage
Sovereign Bank	Relational Investors	3/28/06	Board seats, governance, oppose merger	13D, 14a-12, prelim. proxy filed early	8.4%	Extensive; Pennsylvania law also changed	1 board seat + 1 independent board seat		Settled; 14a-12 war with newspaper ads
Gencorp	Pirate Capital, Gamco	3/31/06	Board seats, governance, maximize value	13D, 14a-12, full contest	8.4% + 9.9%	Suit to avoid Ohio anti-takeover law, by dissident	3/10 board seats won	Dissidents (1/3)	Top 7 holders had 48%

Company	Insurgent	End Date	Principal Issues	Method	Amount Held	Litigation	Result	ISS Advice	Comments
Chiron	Value Act, CAM North American	4/03/06	Sale price	13D	5.2% + 11.5%		\$45 offer raised to \$48	ISS also said \$45 was low	Good result for minimal effort
Reliant Energy	Seneca Capital	4/18/06	Board seats	Publicity	4.0%		1 independent to be named by company		Settled; 14a-9 made company disclose campaign
Star Gas	Third Point	3/8//05 and 4/28/06	Replace CEO; replace General Partner	13D	6.2% + 5.3% +5.4%		CEO and General Partner replaced		Two seasons; two other hedge funds filed 13Gs
Warwick Valley Telephone	Santa Monica Partners	4/28/06	Board seats, maximize value	13D, full contest	2.4%	Untimely nomination, by dissident	Lost vote		Hired banker for strategic alternatives afterwards
Yardville Bank	Seidman entities	5/3/06	Board seats, maximize value	13D, full contest	8.3%	Nominee qualification, by dissident	Lost vote	Management	Bylaw disqualified Seidman himself
Massey Energy	Third Point	5/16/06	Board seats, maximize value	13D, 14a-12, full contest	5.9%	Post-hoc vote counting	Won both board seats sought	Dissidents (1/2)	Cumulative voting
InfoUSA	Dolphin	5/26/06	Board seats, governance, maximize value	14a-12, full contest	3.6%	Books and records, by dissident	Lost vote (moral victory only)	Dissidents	CEO had 40%; use of books & records "dirt"
Life Point Hospitals	Accipter	5/30/06	Board seats	14a-12, mailed	1.8%	Untimely nomination, by dissident	Dropped		Nomination was too late
SCPIE Holdings	Stillwell	6/22/06	Board seats, enhance value	13D, 14a-12, full contest	7.3%	Shareholder list, by dissident	Lost vote	Management	No insurance industry experience
Houston Exploration	Jana	6/27/06	Purchase offer, maximize value	13D, notice of exempt solicitation	12.8%		Value efforts		Only "notice" filing in data base
Sunterra	CD Capital, Chapman Capital, Third Point	7/26/06	Sale, governance, board seat	13D	6.8% + 8.4% + 9.8%		1 board seat, sale efforts		Delisted, CEO fired for cause, SEC investigation
Topps	Pembridge, Crescendo	6/13/05 and 7/28/06	Directors, governance, maximize value	13D, 14a-12, full contest settled on meeting day	7.4%		\$50k, value efforts 1st year; 2nd year 3/10 board seats	Dissidents	1st year settled; 2nd yr. settled for all 3 seats sought
Pep Boys	Barrington, Pirate	8/03/06	Board seats, sale	13D, 14a-12	9.9% + 8.3%		\$200k, 4/10 board Seats		Settled, CEO quit, delayed meeting
Axiom	ValueAct	10/27/05 and 8/07/06	Purchase offer; board seats, governance, enhance value	13D, 14a-12, Preliminary proxy	10.4% ; then 11.9%		Offer rejected; 2/11 board seats, stock buy-back		Offer failed; then settled proxy contest
Heinz	Triam	8/16/06	Board seats, governance, enhance value	13D, 14a-12, short slate rule, full contest	5.5%		2/12 board seats won + 2 independents	Dissidents (3/5)	Dueling contest web sites, much publicity