THE TENSION BETWEEN HEDGE FUND ACTIVISM AND CORPORATE LAW

DRAFT, DRAFT, DRAFT, DRAFT, DRAFT 02.02.16

BERNARD S. SHARFMAN*

ABSTRACT

This Article presents the following thesis: The courts will be over-permissive in allowing Boards to mute the activities of activist hedge funds unless the courts start to recognize the value of hedge fund activism (HFA) as a corrective mechanism and thereby feel the need to make an exception to their traditional approach to judicial review: strong deference to Board authority. We have already seen evidence of the courts not recognizing the value of HFA in *Third Point LLC v. Ruprecht*, a case where the Delaware Chancery court reviewed with approval a discriminatory poison pill meant to keep an activist hedge fund from winning a proxy contest.

In the limited fact patterns where Board actions are taken to mute the activities of activist hedge funds, continued strong deference to Board authority would be a repetition of the mistake made with hostile tender offers and be counter to the objective of shareholder wealth maximization. HFA has a role to play as a corrective mechanism in corporate governance and it is up to the courts to find a way to make sure it continues to have a significant impact despite the courts' inclination to yield to Board authority. In practice, this means that when the plaintiff is an activist hedge fund and the standard of review is the *Unocal* test because issues of

---

* Bernard S. Sharfman is currently an adjunct professor of business law at the George Mason University School of Business, an associate fellow of the R Street Institute, a member of the Journal of Corporation Law's editorial advisory board, and a former Visiting Assistant Professor of Law at Case Western Reserve University School of Law (Spring 2013 and 2014). I want to thank Steven Haas and Stanislav Dolgopolov for their very thoughtful comments. A draft of this paper was presented on January 22, 2016 at a symposium honoring the enduring legacy of Henry G. Manne. The symposium was sponsored by the Law & Economics Center at the George Mason University School of Law. It was a great honor to have been invited to present and I am very grateful to Henry Butler, Todd Zywicki and J.W. Verret for providing me the opportunity to participate. Mr. Sharfman is dedicating this article to his wife, Susan Thea David, and his daughter, Amy David Sharfman.

control are present, a less permissive approach needs to be applied, requiring the courts to exercise restraint in interpreting the actions of activist hedge funds as an attempt to gain control.

If there are no issues of control, then Board independence and reasonable investigation still needs to be the focus. That is, before the business judgment rule can be applied, the courts need to utilize an enhanced level of scrutiny in determining whether the Board is truly independent of executive management or any other insider such as a fellow Board member. As discussed in the Article, Board independence is critical to maximizing the value of HFA. Moreover, reasonable investigation of the activist hedge fund's recommendations should be required to justify Board action taken to mute the fund's influence. Like the *Unocal* test, the burden of proof for establishing independence and reasonable investigation needs to be put on the Board. In sum, what is required in the court's review of Board actions to mute the influence of an activist hedge fund is something similar to the first prong of the *Unocal* test except independence and reasonable investigation is now focused on the Board's evaluation of the fund's recommendations, not the threat to corporate policy and effectiveness.

INTRODUCTION

What role is an activist hedge fund to play in the decision making of a public company?[1] That question is very simple to answer. If a public company is organized as a corporation, which is very likely, and it has not opted out of the default rule that provides managerial control of the company to the board of directors (Board), which is even more likely, then, like any other shareholder, the activist hedge fund can, at most, play only an advisory role. That is, even if the activist hedge fund yells and screams about the company's poor performance, publicly insults the current Board and executive management or threatens a proxy contest to replace some

---

1. "A public company can be defined as a for-profit corporation that is publicly traded on a national exchange or over-the-counter but does not have a controlling shareholder. This type of company is susceptible to the influence of an activist hedge fund." Bernard S. Sharfman, *Activist Hedge Funds in a World of Board Independence: Creators or Destroyers of Long-Term Value?*, 2015 COLUM. BUS. L. REV. 813 (2016). [hereinafter Sharfman, *Activist Hedge Funds*]

or all of the current members of the Board with its own nominees, it is not provided any decision making authority under corporate law.

Therefore, the real corporate governance issue that needs to be addressed is the following: To what extent may a Board act to reduce an activist hedge fund's *influence* in company decision making? Like defensive measures that are utilized by the Board to defend against a hostile bidder, such as the poison pill, this question will ultimately be answered by the judiciary in its statutory interpretation of corporate law's default rule that provides the Board with ultimate management authority. For purposes of this Article, that default rule is Delaware General Corporation Law (DGCL) §141(a): "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."[2]

The judicial review of Board decision making is built on an approach that provides great deference to Board authority. For the overwhelming majority of potential fact patterns, this deferential approach enhances the decision making of public companies and helps move them to shareholder wealth maximization, the objective of Board authority. However, hedge fund activism (HFA), with numerous empirical studies that attests to its role in enhancing shareholder value and target company performance, legitimately questions the value of that deferential approach in some exceptional but very important fact patterns.

The thesis of this Article is as follows: The courts will be over-permissive in allowing Boards to mute the activities of activist hedge funds unless the courts start to recognize the value of hedge fund activism (HFA) as a corrective mechanism and thereby feel the need to make an exception to their traditional approach to judicial review: strong deference to Board authority. We have already seen evidence of the courts not recognizing the value of HFA in *Third Point LLC v. Ruprecht*,[3] a case where the court reviewed with approval a discriminatory poison pill meant to keep an activist hedge fund from winning a proxy contest.[4]

2. DEL. CODE ANN. tit. 8, § 141(a) (2011).
3. No. 9469-VCP, slip op. (Del. Ch. May 2, 2014).
4. *Id.*

There are four important observations about corporate law that support this thesis. First, the default rules of statutory corporate law explicitly provide the Board with unlimited authority to manage the public company. Without modification of this default rule, there is no place for an activist hedge fund in the decision making of a corporation. Second, the parties to the corporate contract of a public company never modify the Board's statutory authority in any substantive way. The courts understand that this private ordering is being sanctioned by statutory corporate law and will feel compelled to act aggressively to protect Board authority. Third, the courts also understand, because of the inherent limitations of being a judge and not a business leader, that the Board and its executive officers are in the best position to determine if a corporate decision is wealth maximizing and feel compelled to defer to their expertise. Fourth, the first three observations imply that when the courts review a Board decision, it will provide strong deference to Board authority. Therefore, even though it has created fiduciary duties to constrain the potentially unlimited power of the Board, it will apply them in a very gentle way. That is, the plaintiffs will have a hard time satisfying the court that the Board has breached its duties. The evidence for this is found in the traditional application of the business judgment rule and the permissive *Unocal* test. This traditional approach to judicial review, without modification, implies being restrained in finding a breach in fiduciary duties when the Board takes actions meant to mute the activities of an activist hedge fund, even when it is clear that the activist hedge fund is acting as a corrective mechanism in corporate governance.

The discussion that follows, when it references state corporate law, has been pragmatically framed in the context of Delaware corporate law. Delaware is the state where the majority of the largest United States companies are incorporated,[5] and its corporate law often serves as the authority that other states look to when

---

5. *See* LEWIS S. BLACK, JR., DEL. DEPT. OF STATE. DIV. OF CORP., WHY CORPORATIONS CHOOSE DELAWARE 1 (2007), http://corp.delaware.gov/whycorporations_web.pdf (stating that Delaware is the "favored state of incorporation for U.S. businesses"). According to the State of Delaware website, Delaware is the legal home to "[m]ore than 50% of all publicly-traded companies in the United States including 64% of the Fortune 500." STATE OF DELAWARE, ABOUT AGENCY, http://corp.delaware.gov/aboutagency.shtml (last visited Nov. 3, 2015).

developing their own statutory and case law.[6] Therefore, the primary examples are from Delaware, but the thinking is meant to be global in nature.

This Article proceeds as follows: Part I briefly describes HFA. Part II describes how HFA operates as a corrective mechanism in corporate governance. This description closely parallels how potential acquirers seek control to correct managerial inefficiencies. This Part closes by providing a theory of shareholder activism that explains how HFA creates value for shareholders and enhances the performance of target companies. This argument has as its foundation Henry Manne's remarkable article, "Mergers and the Market Control."[7] Manne argued that control of a public company was a valuable asset in and of itself if used to correct managerial inefficiencies.[8] Shareholder activism, such as HFA, can be thought of in the same manner, a valuable asset in and of itself if the purpose of such activism is to correct such inefficiencies.[9] Part III discusses how the judiciary's traditional approach to the review of Board decisions, strong deference to Board authority, could potentially be used to reduce the incentives of hedge funds to act as activists. The judiciary could do this by being over-permissive in allowing Boards to mute the activities of activist hedge funds. The judiciary's strong deference to Board authority derives from a strong respect for statutory corporate law's private ordering of authority and its understanding that the Board and its management team, not the courts, are the business experts. Part IV discusses the *Unocal* test as a permissive standard of review and how the application of the test in *Third Point* conforms to the thesis. Part V concludes with general recommendations on how the courts should handle the review of Board actions meant to mute the activities of activist hedge funds.

---

6. *See* Nadelle Grossman, *Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform*, 12 FORDHAM J. CORP. & FIN. L. 393, 397 (2007).

7. Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

8. *Id.* at 112.

9. Bernard S. Sharfman, *A Theory of Shareholder Activism and its Place in Corporate Law*, 82 TENN. L. REV. 791 (2015). [hereinafter Sharfman, *A Theory of Shareholder Activism*]

I. WHAT IS HEDGE FUND ACTIVISM

Shareholder activism refers to "any action(s) of any shareholder or shareholder group with the purpose of bringing about change within a public company *without trying to gain control*."[10] Therefore, shareholder activism exists in a "market for corporate *influence*," not corporate control.[11] Shareholder activism comes in many different forms and HFA[12] is one of them. HFA is a type of performance-driven activism. Performance-driven activism focuses on advocating for significant changes in corporate strategy to increase the market price of a company's stock.[13] It may also act as a bridge between the market for corporate influence and the market for corporate control by encouraging firms to correct inefficiencies through a friendly merger.

HFA typically begins with an unregulated investment fund (the hedge fund) accumulating a significant amount of a public company's stock, usually around 5% to 10% of the shares outstanding.[14] The activist hedge fund makes purchases based on its determination that the target company is suffering from significant *managerial inefficiencies*. It believes that if management adopts its

---

10. Paul Rose & Bernard S. Sharfman, *Shareholder Activism as a Corrective Mechanism in Corporate Governance*, 2014 BYU L. REV. 1014, 1017 (2014). Professor Andreas Jansson describes shareholder activism as outside shareholders who "influence corporate insiders . . . by voicing their opinions in order to affect corporate behavior." Andreas Jansson, *No Exit!: The Logic of Defensive Shareholder Activism*, 10 CORP. BOARD: ROLE, DUTIES & COMPOSITION 16, 16 (2014). Professors Stuart Gillian and Laura Starks note: "Shareholder activists are often viewed as investors who, dissatisfied with some aspect of a company's management or operations, try to bring about change within the company without a change in control." Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, 19 J. APPL. CORP. FIN. 55, 55 (2007).

11. Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 58 (2011). As has been pointed out by Henry Manne in an email exchange with this author, the development of the market for corporate influence has no doubt been helped by federal securities and state corporate laws that have greatly inhibited the volume of hostile takeover transactions. E-mail from Henry G. Manne, Professor Emeritus of Law, Geo. Mason Univ., to Bernard S. Sharfman, Assistant Professor of Law, Case W. Univ. Sch. L. (Sept. 11, 2013) (on file with author).

12. Hedge fund activism is more formally referred to as offensive shareholder activism. *See* Cheffins & Armour, supra note 11, at 56–57.

13. Rose & Sharfman, *supra* note 10, at 1018.

14. *See* Cheffins & Armour, supra note 11, at 56.

recommended strategies then the value of the company's common stock would significantly increase and the company's performance would improve.[15]

In order for an activist hedge fund to maximize returns, it cannot hold the target company's stock for a long period of time.[16] Once it becomes apparent that it has either succeeded or failed in its mission to correct managerial inefficiencies, it must move on to the next target in order to maximize its number of interventions and thus the profits of its own investors.[17] It is not possible for investors like Warren Buffet and his company, Berkshire Hathaway, to participate in such corrective activism precisely because they have much longer holding periods.[18] Therefore, such long-term investors must yield this market to activist hedge funds.[19]

Activist hedge funds can be categorized as a very special subset of what Zohar Goshen and Gideon Parchomovsky call "information traders."[20] These traders participate in the financial markets based on non-public research and analysis and "are willing and able to devote resources to gathering and analyzing information as a basis for their investment decisions."[21] They "look for differences between value and price based on the information they possess . . . [t]hen

---

15. *Id.*

16. Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1732 (2008). [hereinafter Brav, et al. *Hedge Fund Activism, Corporate Governance*]

17. Rose & Sharfman, *supra* note 10, at 1046.

18. *Id.*

19. *Id.*

20. Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 721–723 (2006). Other information traders include acquirers in the market for corporate control, money managers, and even market professionals who specialize in providing recommendations to investors based on non-public research and analysis in exchange for compensation. *Id.* at 720–726. Non-information traders include "insiders," such as directors and executive management who have access to non-public information but are significantly restricted in the trading of that information; "liquidity traders," who invest in passive, index funds; "noise traders," who invest based on fads, rumors or old information; and "market makers," "professionals who facilitate trading and maintain a market for securities by offering to buy or sell securities on a regular basis." *Id.*

21. *Id.*

trade to capture the value of their informational advantage."[22] Information traders move security prices toward their fundamental values and are in essence "the agents who render markets efficient."[23]

The most common type of information trader is the *value investor*.[24] Value investors devote whatever limited time, resources, and skill they have to valuation, not to the process of trying to correct managerial inefficiencies through an attempt to acquire control or hedge fund activism.[25] Value investors incorporate information on *managerial inefficiencies* into the price of a company's stock by *voting with their feet*,[26] i.e., selling their shares when they perceive managerial inefficiencies, rather than becoming proactive in the corporate governance of any particular firm.[27]

By contrast, being an activist hedge fund means not just identifying managerial inefficiencies, but also raising large amounts of capital in order to make a significant investment in the company. It also requires possessing both the expertise necessary to make the recommended changes that will correct the managerial inefficiencies and having the time and financial resources available to vigorously advocate for change.[28] Moreover, being an activist hedge fund may mean giving up the benefits of portfolio diversification as the acquisition becomes an overweighed investment in the information trader's portfolio; exposing the activist hedge fund to non-systematic risk.[29]

---

22. *Id.* at 726 (citation omitted).

23. *Id.* at 719.

24. Rose & Sharfman, *supra* note 10, at 1033.

25. *Id.*

26. According to Professors Armen Alchian and Harold Demsetz in their seminal article, *Production, Information Costs, and Economic Organization*, "Any shareholder can remove his wealth from control by those with whom he has differences of opinion. Rather than try to control the decisions of the management, which is harder to do with many stockholders than with only a few, unrestricted salability provides a more acceptable escape to each stockholder from continued policies with which he disagrees." Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 788 (1972).

27. Sharfman, *A Theory of Shareholder Activism*, *supra* note 9, at 805.

28. *Id.*

29. *Id.*

II. HOW HEDGE FUND ACTIVISM WORKS AS A CORRECTIVE MECHANISM

Numerous empirical studies demonstrate that HFA increases the wealth of shareholders and improves the performance of the public companies it targets.[30] These studies support the argument that activist hedge funds are being utilized as a *corrective mechanism* in the governance of a public company.[31] According to Sharfman, "a corrective mechanism is defined as a part [or potential part] of a

---

30. *See* Brav, et al. *Hedge Fund Activism, Corporate Governance*, *supra* note 17 at 1731; *see also* Nicole M. Boyson & Robert M. Mooradian, *Corporate Governance and Hedge Fund Activism*, 14 REV. DERIVATIVES RES. 169, 175–78, 201 (2011) (examining data from 1994–2005 and finding that hedge fund activism improved by short and long-term performance of companies); Christopher P. Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists*, 14 J. CORP. FIN. 323, 324 (2008) (finding that in a control group containing hedge funds that filed Schedule 13Gs, "firms targeted by hedge funds for active purposes earn larger, positive [returns] than firms targeted by hedge funds for passive purposes"); Robin M. Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON. 362, 374 (2009) (finding that "activists are most successful at creating value when they are able to [force] a change in control"); Dionysia Katelouzou, *Myths and Realities of Hedge Fund Activism: Some Empirical Evidence*, 7 VA. L. & BUS. REV. 459, 479 (2013) (examining empirical results consistent with these studies but focusing on hedge fund activity outside the United States); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187, 213, 217–18 (2009) (focusing on activist campaigns by both hedge funds and other types of entrepreneurial activists, the study found that both types of campaigns produced average abnormal returns for target shareholders); Alon Brav et al., *Shareholder Power and Corporate Innovation: Evidence from Hedge Fund Activism* (Ind. Univ., Kelly Sch. of Bus., Working Paper No. 2014-05, 2014) (finding a link between improvements in innovation efficiency and hedge fund activism at firms with a diverse set of patents as a result of the activism leading to a more targeted approach to innovation); C.N.V. Krishnan et al., *Top Hedge Funds: The Importance of Reputation in Shareholder Activism* (Vand. L. Sch., Law & Economics Working Paper No. 15-9, 2015) (discussing that hedge fund activism continues to generate positive announcement–period abnormal stock returns using a dataset collected from 2008 through mid-2014); Shane Goodwin, *Myopic Investor Myth Debunked: The Long-Term Efficacy of Shareholder Advocacy in the Boardroom* 10–13 (June 13, 2014) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2450214 (reporting excess returns for activist hedge funds who gain board representation). But see, Martijn Cremers, Erasmo Giambona, Simone M Sepe, and Ye Wang, *Hedge Fund Activism and Long-Term Firm Value* (November 19, 2015), available at http://ssrn.com/abstract=2693231 or http://dx.doi.org/10.2139/ssrn.2693231.

31. Rose & Sharfman, *supra* note 10, at 1030–33.

public company, other than the [current] Board or executive management, which may have, from time to time, superior decision-making skills in the making of major corporate decisions."[32]

But how does HFA actually work as a corrective mechanism? Since the activist hedge fund is a participant in the stock market and is presumed to be targeting the correction of managerial inefficiencies, it should not be surprising that this Article finds guidance in Henry Manne's seminal article, *Mergers and the Market for Corporate Control*.[33]

A. The Potential Acquirer as a Corrective Mechanism in Corporate Governance

In *Mergers and the Market for Corporate Control*, Henry Manne argued that "the control of corporations may constitute a valuable asset" in and of itself, an asset that "exists independent of any interest in either economics of scale or monopoly profits," if the acquirer takes control with the expectation of correcting managerial inefficiencies.[34] Manne's theory is based on the simple but brilliant premise that there is "a high positive correlation between corporate managerial efficiency and the market price of shares of that company."[35] Such a premise means that the price of a public company's stock will in part reflect managerial performance.

Critical to this theory is the existence of a liquid stock market where potential acquirers could assess the price of the stock versus what the price could be with better management.[36] Manne provides the following description of how the market for corporate control operates:

---

32. *See* Sharfman, *A Theory of Shareholder Activism, supra* note 19, at 792-93. The inserted language in brackets changes the original definition to include potential acquirers who want to replace current Board members so as to implement new strategies. The definition is based on Kenneth Arrow's observation that "from time to time it may be more efficient to allow for a corrective mechanism to exist in a large organization. That is, the central authority recognizes that a part of the organization outside itself may have superior information or decision-making skills." Rose & Sharfman, *supra* note 10, at 1015, citing KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 74-75 (1974).

33. Manne*, supra* note 7.

34. *Id.* at 112.

35. *Id.*

36. *Id.* at 113 ("Share price, or that part reflecting managerial efficiency, also measures the potential capital gain inherent in the corporate stock.").

> Briefly, the market for corporate control in our system operates in the following manner: if an existing corporation with publicly traded shares is poorly managed, holders of those shares will respond by selling. This will drive the price down to the point indicated by the quality of management which the corporation is receiving. As the price of securities of any corporation is thought to be low relative to the price that would be generated by more efficient managers, the stage is set for the critical functioning of the market for corporate control. Outsiders, …, will respond to the opportunity to make substantial capital gains (not necessarily in the tax sense) by buying control, managing the company efficiently, and then perhaps disposing of the shares. It is not necessary that they remain permanently to manage the business.[37]

Critical to the successful operation of Manne's market for corporate control is the presence of value investors. A low share price[38] resulting from a significant number of value investors "voting with their feet"[39] provides an opportunity for an information trader who is willing and able to make the investment necessary in acquiring control and has the required expertise to correct the managerial inefficiencies that exists.[40] Once these inefficiencies have been corrected, the information trader, whether a friendly or hostile acquirer, can then sell its investment for a large profit if it so

---

37. Henry G. Manne, *Cash Tender Offers for Shares – A Reply to Chairman Cohen*, 1967 DUKE L.J. 231, 236 (1967) (citations omitted).

38. According to Manne:

> The lower the stock price, relative to what it could be with more efficient management, the more attractive the takeover becomes to those who believe that they can manage the company more efficiently. And the potential return from the successful takeover and revitalization of poorly run company can be enormous.

Manne, *supra* note 7, at 113.

39. For example, in *Jones v. Harris Associates L.P.*, Judge Easterbrook noted how investors will simply sell their investments if they are not happy with them: "The trustees (and in the end investors, who vote with their feet and dollars), rather than a judge or jury, determine how much advisory services are worth." 527 F.3d 627, 632 (7th Cir. 2008).

40. Manne, *supra* note 7, at 113.

desires.[41] As a result, the potential acquirer, by targeting its activities to correcting managerial inefficiencies, is also acting as a corrective mechanism in corporate governance.

B. The Activist Hedge Fund as a Corrective Mechanism in Corporate Governance

An activist hedge fund works in a similar manner to the potential acquirer who is seeking to correct managerial inefficiencies.[42] The difference being that the activist hedge fund is attempting to correct inefficiencies through its influence, not its control of the company.[43] It utilizes value investors who are voting with their feet as an opportunity to acquire a significant but not controlling share in a company at a relatively low price with the expectation that the inefficiencies will eventually be corrected through its efforts and the price will rise to reflect these enhanced efficiencies.[44] Once these enhanced efficiencies have been fully reflected in the stock price, the activist hedge fund can then sell its investment for a large profit if it so desires.[45] In essence, HFA provides a corrective function similar to, but with less investment and more advocacy than, what is found in the market for corporate control.[46]

Moreover, the similarities between potential acquirers and activist hedge funds as corrective mechanisms are even more striking when one looks closer at the empirical results and sees that the wealth enhancement created by HFA has been primarily a result of recommendations that have led to "the sale of the company or changes in business strategy, such as refocusing and spinning-off noncore assets."[47] The results suggest that the activist hedge fund is

---

41. *Id.*
42. Sharfman, *A Theory of Shareholder Activism*, *supra* note 10, at 805-807.
43. *Id.*
44. *Id.*
45. *Id.*
46. *Id.*
47. Brav et al., *Hedge Fund Activist, Corporate* Governance, *supra* note 16, at 1731; *see also* Greenwood & Schor, *supra* note 30, at 363 (finding that abnormal positive returns only existed when the activism was associated with the ultimate sale of the target to a third party). *See also*, Nicole M. Boyson, Nickolay Gantchev, and Anil Shivdasani, *Activism Mergers* (November 10, 2015), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2677416. An example of a spin-

utilizing its influence to convince a reluctant Board to seek a friendly merger in order to correct the company's managerial inefficiencies, a very desirable outcome in Manne's theory of corporate control.

Therefore, a theory of shareholder activism can be stated as a *corollary* to Manne's theory of corporate control: "In the context of public companies, shareholder activism *may* constitute a valuable asset in and of itself if the goal of such activism is to enhance managerial efficiency."[48] Such an argument utilizes Manne's premise that there is "a high positive correlation between corporate managerial efficiency and the market price of shares of that company"[49] and assumes that the activist holds enough shares in the company to earn a large enough return on the expected increase in the stock price to cover the costs of its activism.[50]

This theory of shareholder activism purposely tries to mimic the language used in Manne's theory of corporate control. When stating his theory, Manne was trying to make the point that not all takeovers of competitors (horizontal mergers) were bad.[51] That is, those acquirers that were targeting the correction of managerial inefficiencies enhanced shareholder value and improved the performance of target companies. In the same vein the theory of shareholder activism is trying to make the point that not all shareholder activism is bad. More specifically, there is one type of shareholder activism that has been found to be value enhancing and that is HFA.

C. HFA and Board Independence

Value investors, by voting with their feet, provide negative signals to the stock market on how well a company is doing.[52] These negative signals, in the form of a falling stock price, are also being

---

off is found in Relational's recommendation that Timken Co. spin off its steel operations into a separate public company. *See* Rose & Sharfman, *supra* note 10, at 1036, and accompanying text.

48. *Id.* at 804. Where the theory was first stated.

49. Manne, *supra* note 7, at 112.

50. Sharfman, *Activist Hedge Funds, supra* note 1, at 831.

51. Manne, *supra* note 7, at 110–11.

52. Sharfman, *Activist Hedge Funds, supra* note 1, at 842-43.

sent to the target Board.[53] Perhaps the stock price fall is not a reflection of managerial competence, but simply a result of business conditions that cannot be controlled.[54] Here is where activist hedge funds can help refine the negative signals being sent by value investors.[55] The actions of the activist hedge fund provide additional and confirming signals to the Board and other stock market participants that managerial inefficiencies may exist at the company.[56] They not only identify alleged inefficiencies but they also provide the Board with recommendations on how those inefficiencies can be corrected.[57]

Board independence can significantly enhance the value of the signals provided by the activist hedge fund.[58] This argument can be summarized as follows: "An activist hedge fund can create long-term value at a public company if the Board has enough independence to act as an impartial arbitrator deciding between the advices provided by executive management and the activist hedge fund."[59] The role of executive management is critical to understanding this argument as corporate law authorizes the Board to delegate the bulk of its decision-making authority to executive management.[60] Executive management is a locus of authority created by delegation, separate from but under the control of the Board, not only runs the company on a day-to-day basis but also provides the Board with recommendations on what investment projects and strategies the company should proceed with and then implements them with Board approval.[61] The management expertise created by this delegation cannot be understated.

Independence allows the Board to be receptive to stock market signals[62] and recognize other parts of the organization, if only on a

---

53. *Id.*
54. *Id.*
55. *Id.*
56. *Id.*
57. *Id.*
58. *Id.* at 843-46.
59. *Id.* at 822.
60. DEL. CODE ANN. tit. 8, § 142(a) (2010).
61. *Id.*
62. *Id.* citing Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1563 (2007).

temporary basis, as competing loci of authority with executive management when they are perceived to add value to the company's decision-making.[63] According to Kenneth Arrow, decision-making "[e]rror is unnecessary when the information is available somewhere in the organization but not available to or not used by the authority."[64] In the context of the public company, the activist hedge fund may serve as that temporary competing locus of authority. With an adequate level of independence, a Board can arbitrate between the two loci of authority and then determine which of the following paths it should pursue: "the one recommended by executive management, the one recommended by the activist hedge fund, or perhaps a combination of both."[65]

III. HFA'S POTENTIAL PROBLEM WITH CORPORATE LAW

Empirical studies tell us that HFA can act as a corrective mechanism in corporate governance, enhancing shareholder value and improving the operating performance of the target company. However, the value of this corrective mechanism may be lost if the corrective mechanism is ignored by the Board. That is why having an adequate level of Board independence is critical to maximizing the probability that the recommendations of the activist hedge fund will be critically and impartially considered by the Board. But being ignored by the Board is not the only way this value can be lost. Another way is if corporate law reduces the incentives of a hedge fund to participate in the stock market as an activist, similar to the way the courts dealt with hostile bidders and their use of tender offers. This Part discusses how the judiciary's traditional approach to the review of Board decisions, strong deference to Board authority, could potentially be used to reduce the incentives of hedge funds to act as activists. The judiciary can do this by being over-permissive in allowing Boards to mute the activities of activist hedge funds. The judiciary's strong deference to Board authority derives from a strong respect for statutory corporate law's private ordering of authority and its understanding that the Board and its management team, not the courts, are the business experts.

---

63. *Id.* at 843-846.
64. KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 74 (1974).
65. Sharfman, *Activist Hedge Funds, supra* note 1, at 847.

A. Statutory Corporate Law's Private Ordering

Corporate law primarily provides default, not mandatory rules. This allows for private ordering of corporate authority through a process of creating, modifying and repealing charter and bylaw amendments.[66] Private ordering is considered efficient because it allows for the implementation of market driven corporate governance arrangements.[67] That is, it "allows the internal affairs of each corporation to be tailored to its own attributes and qualities, including its personnel, culture, maturity as a business, and governance practices."[68] In effect, "observed governance choices are the result of value-maximizing contracts between shareholders and management."[69]

1. DGCL §141(a)

For purposes of this Article, the most critical default rule is DGCL §141(a).[70] On its face, this statutory rule provides the Board with unlimited managerial authority. This default rule is so universally implemented in its unmodified form that it most likely could have been written as a mandatory rule without significantly

---

66. Jill E. Fisch, *Leave it to Delaware: Why Congress Should Stay out of Corporate Governance*, 37 DEL. J. CORP. L. 731, 743 at n.80 (2013).

67. According to Professor Jonathan Macey:

> [B]ecause informal norms generate outcomes that are generally welfare-enhancing, while law at best generates outcomes that are mixed (and tend strongly towards the welfare-reducing), informal norms should come with a strong presumption of legitimacy. Formal legal rules are likely to be inefficient at best and amorally redistributive at worst. Thus, under a wide range of circumstances, such as when society is interested in maximizing utilitarian considerations, and when society is interested in resolving standard legal disputes within groups, lawmakers are unlikely to improve upon the customary rules the group develops through voluntary, private interaction.

Jonathan R. Macey, *Public and Private Ordering and the Production of Legitimate and Illegitimate Legal Rules*, 82 CORNELL L. REV. 1123, 1140 (1997).

68. Troy A. Paredes, Comm'r, U.S. Sec. & Exch. Comm'n, Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations (May 20, 2009), available at www.sec.gov/news/speech/2009/spch052009tap.htm

69. David F. Larcker, Gaizka Ormazabal and Daniel J. Taylor, *The Market Reaction to Corporate Governance Regulation*, 101 J. FIN. ECON. 431, 431 (2011).

70. DEL. GEN. CORP. L. §141(a) (2011).

restricting the contracting parties' abilities to enter into private ordering.[71] That is, if there is truly a bargaining process that goes on between contracting parties in a public company, then there seems to be overwhelming support for allowing the Board to retain its statutory authority.

Despite the inhibiting factor that the Board is given sole authority to initiate charter amendments that would limit its own authority, if the contracting parties wanted certain shareholders, such as activist hedge funds, to share the Board's default authority under DGCL §141(a), then you would expect to see at least some public companies having such charter provisions. However, public companies never modify this default rule in any substantive way.[72] This lack of modification needs to be acknowledged as the first and most fundamental step in such a company's private ordering process.

Recognition by the contracting parties that the Board has superior decision making capabilities, based primarily on superior information including confidential information, is the rationale that explains why the bargaining process always allows DGCL §141(a) to be incorporated without substantive modification into a public company's charter. The parties recognize that a centralized, hierarchical authority is necessary for the successful management of a public company that can become extremely large in size.[73] It also

---

71. Bernard S. Black, *Is Corporate Law Trivial: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 551 (1990).

72. *Id. See also*, Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) ("A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation."), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000).

73. ROBERT CHARLES CLARK, CORPORATE LAW, app. at 801–16 (1986) (arguing that "facilitation of cooperation" allows for efficiently completing large tasks). According to Kenneth Arrow, information scattered over a large organization must be both filtered and transmitted to a centralized authority in order for a large organization to make informed decisions and minimize error in decision making. KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 68-70 (1974). Alan Alchian and Harold Demsetz argued that a centralized authority was necessary to eliminate the problems associated with having a large number of shareholders:

> If every stock owner participated in each decision in a corporation, not only would large bureaucratic costs be incurred, but many would shirk the task of becoming well informed on the issue to be decided, since the losses associated with unexpectedly bad decisions will be borne in large part by the many other corporate shareholders. More effective control of corporate activity is achieved for most purposes by transferring decision authority to a smaller

explains why the Board is given exclusive authority to initiate charter amendments, the process by which substantive authority is distributed in a public company.

Importantly, it also explains why the Board, under DGCL 142(a),[74] is given the authority to create executive management positions and select the individuals to fill those positions. The result is that the default rules of statutory corporate law provide for only two loci of authority, the Board and by delegation, executive management. There is no room for an activist hedge fund to function as a third locus of authority without a substantive modification of these default rules, a modification that does not happen. Therefore, the courts will legitimately be suspicious of any sign that activist hedge funds are trying to usurp this allocation of corporate authority, an allocation that has been sanctioned by statutory corporate law. Thus, the activist hedge fund, without the legal authority to make corporate decisions, is legally confined to the market for corporate influence.

2. The Objective of Corporate Authority

Even though statutory corporate law is silent on the topic and courts have been reluctant to opine, it is easy to make the argument that the objective of authority under corporate law is shareholder wealth maximization. Under a nexus of contracts understanding of the firm, shareholders are the sole claimants to the residual cash flows generated by the firm, since other parties transacting with the corporation can adequately protect themselves by contract.[75] That is,

---

> group, whose main function is to negotiate with and manage (renegotiate with) the other inputs of the team.

Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 788 (1972).

74. DEL. CODE ANN. tit. 8 § 142(a) (2015).

75. This would include communities who provide tax credits and abatements to companies who agree to remain or relocate to their geographic area, vendors who customize their production to provide specialized inputs, and researchers who invest many years of specialized effort and skill as employees, three examples of other parties that transact with public companies via contract. Under a team production approach to corporate governance, an approach that is not taken here, these three examples would represent persons or entities that make specialized investments in the public company that have little or no value outside the company. See Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 272 (1999). Like equity investors, these stakeholders have made firm-

they are the parties to the corporate contract that have the greatest risk of ending up with nothing as a result of their dealings with the corporation. The Board may have ultimate authority to act and make decisions under the default rules of corporate law, *but* that authority is only given by shareholders if the Board acts to enhance shareholder value. Moreover, a Board and executive management targeting shareholder wealth maximization means that all other parties that have contracted with the corporation must be paid off prior to the shareholders receiving a residual, if any.[76] Therefore, these other contracting parties should be supportive of shareholder wealth maximization as the objective of corporate authority. As stated by Henry Manne, the result is an example of "pure positive economics"[77] and should be accepted as such. In sum, this objective is what all parties to the corporate contract agree to and what the courts should be expected to enforce.

B. HFA and Judicial Review

While the default rules of statutory corporate law provide the framework for the private ordering of corporate authority, the courts, through statutory interpretation, fill in the terms of this private ordering that were not resolved ex ante.[78] More specifically, this process allows us to understand what an unmodified DGCL §141(a) means under fact patterns that the parties to the corporate contract did not contemplate ex ante.

As already noted, on its face, an unmodified DGCL §141(a) provides a Board with unlimited authority to manage the company. While the process of statutory interpretation has led to the creation of fiduciary duties to limit Board authority under DGCL §141(a), it has also led to standards of review, such as the business judgment rule ("a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith

---

specific investments and therefore should have equivalent standing as claimants on the residual cash flows generated by the firm. *Id.* at 274–76.

76. FRANK H. EASTERBROOK AND DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW at 38 (1991) ("[M]aximizing profits for equity investors assists the other "constituencies" automatically.")

77. E-mail from Henry G. Manne, Professor Emeritus of Law, Geo. Mason Univ., to Bernard S. Sharfman (December 29, 2012) (on file with author).

78. FRANK H. EASTERBROOK AND DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW at 35.

and in the honest belief that the action taken was in the best interests of the company")[79] and to a lesser extent the *Unocal* test, that provide significant deference to Board authority.

If the courts accept shareholder wealth maximization as the objective of corporate authority, then it is not hard to imagine that courts equate this objective with deference to Board authority. Judges recognize that the Board is the locus of authority in a company that is in the best position to make corporate decisions that maximize shareholder wealth. They also recognize it is not their role to second guess these decisions unless they are tainted with a breach of fiduciary duties.[80] Even though they definitely have the brains, judges recognize that they are lacking in information, decision-making skills, expertise, and interests (i.e., lacking a stake in the company) relative to corporate management.[81] As stated by the Michigan Supreme Court in the famous case of *Dodge v. Ford Motor Co.*,[82] "[J]udges are not business experts."[83]

> Moreover, determining whether a business decision is shareholder wealth-maximizing is not just about plugging in a formula and calculating the result, which any computer or calculator can do. Rather, it refers to the specific formula that will be utilized by management to determine if a particular decision maximizes shareholder wealth. One can think of this in terms of a mathematical formula where the decision maker is given the responsibility of choosing the variables and estimating the coefficients of those variables. This requires many sources of knowledge and expertise that chancellors and judges lack, including experience in the particular business that the company may be in, product and company knowledge, management skills, financial skills, creative and analytical thinking pertinent to a company's business, confidential information, and so on. For example, who has the knowledge and expertise to decide whether a distinctive corporate culture

---

79. Smith v Van Gorkom, 488 A.2d 858, 872 (Del. 1985) citing Aronson v Lewis, 473 A.2d 805, 812 (1984).

80. Bernard S. Sharfman, *Shareholder Wealth Maximization and its Implementation under Corporate Law*, 66 FLA. L. REV. 389, 406-409 (2014).

81. *Id.*

82. *Id.* at 407 citing 170 N.W. 668 (Mich. 1919).

83. *Id.* citing 170 N.W. 668, at 684.

> enhances or detracts from shareholder value? The clear answer is that the board and its executive management are the proper locus of authority for making this decision.[84]

As long as the courts do not find a breach in a Board's fiduciary duties, they typically do not want to get involved in that determination.[85] Finally, when the courts do get involved, they modestly aspire to identify a fair result, not the one that maximizes wealth.[86]

Indeed, this presumption that the Board provides the corporation with superior decision making is endorsed by the courts through its explanation of why it applies the business judgment rule:

> The "business judgment" rule is a judicial creation that presumes propriety, under certain circumstances, in a board's decision. Viewed defensively, it does not create authority. In this sense the "business judgment" rule is not relevant in corporate decision making until after a decision is made. It is generally used as a defense to an attack on the decision's soundness. The board's managerial decision making power, however, comes from § 141(a). The judicial creation and legislative grant are related because the "business judgment" rule evolved to give recognition and deference to directors' business expertise when exercising their managerial power under § 141(a).[87]

According to Easterbrook and Fischel, "the application of the business judgment rule contributes to the efficient management that shareholders desire. There is no reason to think that courts generally could improve the performance of managers. Courts lack the experience and information necessary to make business decisions." [88] What is desired by the courts in terms of corporate authority can be summarized in the following statement by Stephen Bainbridge: the "[p]reservation of managerial discretion should

---

84. *Id.* at 408.
85. *Id.* at 409-411.
86. *Id.*
87. Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981).
88. Frank H. Easterbrook and Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARVARD L. REV. 1161, 1196 (1981). [hereinafter Easterbrook & Fischel, *Responding to a Tender Offer*]

always be the null hypothesis."[89]

In sum, when a court is asked to review the actions of a Board in response to the activities of activist hedge funds, the court will have to decide whether the actions of the Board breached its fiduciary duties. It will do so knowing that strong deference to Board authority has traditionally been the judiciary's best approach to making sure that corporate decisions are wealth maximizing. Most importantly, it will not want to upset the allocation of authority that has already occurred under corporate law's private ordering scheme. Therefore, it should be expected that a court will continue to apply fiduciary duties in its traditional gentle way, making it very difficult for plaintiffs to show to the courts' satisfaction that a breach has occurred.

C. The Tension Between HFA and Corporate Law

This approach to judicial review, strong deference to Board authority, whether in the application of the business judgment rule or the permissive *Unocal* test, is where the tension arises between HFA and corporate law. Tension results when, in exceptional fact patterns, an effective corrective mechanism such as HFA challenges the courts' deferential approach. That is, when strong theoretical arguments and strong empirical evidence suggest that strong deference to Board authority may not be optimal in judicial review. This tension was evident in the recent case of *Third Point LLC v. Ruprecht*.[90]

IV. THE *UNOCAL* TEST AND *THIRD POINT*

In the recent case of *Third Point*, the *Unocal* test was used to review the Board's use of a discriminatory poison pill meant to keep an activist hedge fund from winning a proxy contest. As discussed below, the court's review in *Third Point* is consistent with the thesis that the courts will be over-permissive in allowing Boards to mute the activities of activist hedge funds unless the courts start to recognize the value of HFA as a corrective mechanism and thereby

---

89. Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VANDERBILT L. REV. 83, 109 (2004).

90. No. 9469-VCP, slip op. (Del. Ch. May 2, 2014).

feel the need to make an exception to their traditional approach to judicial review: strong deference to Board authority.

A. The *Unocal* Test

The *Unocal* test was created by the courts as a standard of review for Board actions to ward off a hostile bidder (defensive measures). It provides "enhanced scrutiny"[91] when issues of control exist and therefore a heightened suspicion that Board action may be as a result of bad faith or for purposes of entrenchment.[92] There are two prongs to the *Unocal* test. The first prong requires the Board, who has the burden of proof, to demonstrate "reasonable grounds for believing that a danger to corporate policy and effectiveness existed."[93] "Directors satisfy [this prong] by demonstrating "good faith and reasonable investigation."[94] Good faith in this context can be understood as the Board having a "sincere belief" that such a threat existed.[95] Reasonable investigation is linked with the process of being informed under the business judgment rule.[96] If the Board can show that it was informed, then reasonable investigation has been satisfied.[97] To show reasonable investigation without more, "direct investigation, receipt of professional advice, and personal observations" will suffice.[98] Evidence of "good faith and reasonable investigation" is "materially enhanced ... by the approval of a board comprised of a majority of outside independent directors."[99]

---

91. Enhanced scrutiny refers to an "enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred." *Unocal*, 493 A.2d at 954.

92. Moran v. Household Int'l, Inc., 500 A.2d at 1356.

93. *Unocal*, 493 A.2d at 955. The source of this first prong was *Cheff v. Mathes*.

94. *Id.*

95. The equivalency of "good faith" and "sincere belief" was established in Cheff v. Mathes, the case that provided the first prong of the *Unocal* test. *See* Leo E. Strine Jr., Lawrence A. Hamermesh, R. Franklin Balotti, and Jeffrey M. Gorris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L. J. 629, 670 (2010) citing Cheff v. Mathes, 199 A.2d 548, 554 (Del. 1964).

96. Moran v. Household Int'l, Inc., 500 A.2d at 1356.

97. *Id.*

98. Cheff v. Mathes, 199 A.2d at 556.

99. *Id.* at 555. Prior to applying *Unocal*'s second prong, the *Blasius* standard of review must be included in the court's review when a contested election (proxy contest) is affected by the Board actions:

When the *primary purpose* of a board of directors' defensive measure is to

The second prong, "a proportionality test, [must be] satisfied by a demonstration that the . . . defensive measure was reasonable in relation to the threat posed."[100] The review for proportionality is another two-part test.[101] First, the court must determine whether the defensive measure was "draconian, by being either preclusive or coercive."[102] Second, "if the Board's response to the threat was [determined] not [to be] draconian, the Court must then decide [if the defensive measure] fell 'within a range of' reason.[103]

Under the *Unocal* test, the courts have been very permissive in allowing Boards to maintain and implement defensive measures, such as poison pills, for purposes well beyond protecting shareholders from "coercive two-tier tender offers,"[104] even allowing Boards to implement defensive measures to protect against all-cash offers for 100% of the company's shares.[105] As Mary Siegel reports, even though the burden of proof is on defendants, defensive measures reviewed under the *Unocal* test have an overall survival rate of 79%.[106] Of course, as already discussed, from the perspective of a judge or chancellor this approach makes sense. The Board, not the court, is in the best position to evaluate whether a defensive

---

> interfere with or impede the effective exercise of the shareholder franchise in a contested election for directors, the board must first demonstrate a compelling justification for such action as a condition precedent to any judicial consideration of reasonableness and proportionately.

MM Cos. v. Liquid Auto, Inc., 813 A.2d 1118, 1132 (citing Stroud v. Grace, 606 A.2d 75, 92 n.3 (Del. 1992)). For a discussion of how the *Blasius* standard was applied in Third Point LLC v. Ruprecht, *see* Sharfman, *A Theory of Shareholder Activism*, *supra* note 10, at 826 - 831.

100. Third Point LLC v. Ruprecht, No. 9469-VCP, slip op. at 38 (quoting *Unocal*, 493 A.2d at 955).

101. *Id.* at 34.

102. *Id.* at 38 (quoting Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1367 (Del. 1995)).

103. *Id.* at 38 (quoting *Unitrin*, 651 A.2d at 1367).

104. Jonathan R. Macey, *The Politicization of American Corporate Governance*, 1 VA. L. & BUS. REV. 10, 35 (2006) ("Courts have failed to restrict the use of poison pills to their proper context—the regulation of coercive two-tiered tender offers.") [hereinafter, Macey, *The Politicization of American Corporate Governance*]

105. *Id.* citing Paramount Communications v. Time Inc., 571 A.2d 1140, 1142 (Del. 1989) (The court allowed Time to retain poison pill despite all-cash offer.)

106. Mary Siegel, *The Illusion of Enhanced Review of Board Actions*, 15 U. OF PENN. J. BUS. L. 599, 621 (2013).

measure maximizes shareholder wealth.

Unfortunately, the over-permissive approach taken under the *Unocal* test has created the classic example of how corporate law can destroy the value of a corrective mechanism. In this case it is the hostile bidder who is the corrective mechanism. The courts, along with the Williams Act and state takeover statutes, have played a major role in eliminating an important technique for correcting managerial inefficiencies, the hostile tender offer.[107] According to Macey when discussing the permissive use of the poison pill:

> Thus, by judicial fiat, the Delaware courts have removed from the marketplace the hostile tender offer, which is the most powerful corporate governance device in the shareholders' corporate governance arsenal. As Baums and Scott presciently have observed, "Delaware jurisprudence seems to be willing, in substance . . . to give management something approaching an absolute veto over hostile tender offers despite overwhelming evidence that they confer large benefits on target shareholders." Again, just as courts and legislatures have undermined the vitality of credit rating agencies and accounting firms, they have undermined the market for corporate control. [108]

The inability to identify a nuanced approach that would have allowed hostile tender offers to survive as a corrective mechanism must be considered a judicial failure. Once the legal rule was put into place that allowed a poison pill to easily defend against a hostile tender offer, there were no longer any incentives for a hostile bidder to search for companies with managerial inefficiencies who resisted their correction through a friendly merger.[109] Thus, corporate law had effectively killed off the hostile tender offer Viewed from this perspective, Frank Easterbrook and Daniel Fischel's proposal to correct this failure through a mandatory legal rule, the "passivity rule," a rule that would not allow Boards to take defensive actions, seems reasonable as a means to enhance shareholder wealth even in

107. Macey, *The Politicization of American Corporate Governance*, supra note 102, at 36.

108. *Id.*

109. Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 Stan. L. Rev. 1, 1 (1982). [Hereinafter, Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*]

a world where it is usually preferable to have private ordering.[110]

Moreover, even though it is beyond the scope of this Article, perhaps it is time to consider changes to statutory corporate law that would limit the use of the poison pill when the hostile bidder is making an all-cash all-shares tender offer unless it is permitted in the original charter or through a charter amendment. Such statutory changes may allow hostile tender offers to reappear in the market for corporate control in a limited but significant way. In sum, the elimination of hostile tender offers was a loss for efficient decision making and shareholder wealth maximization. The hope is that history will not repeat itself when the courts review Board actions in the context of HFA.

B. *Third Point*

In determining how to apply the *Unocal* test to fact patterns involving HFA, the courts will need to take into consideration the numerous empirical studies that have found HFA to be wealth enhancing for shareholders. This should give the courts pause to take any actions that would significantly reduce the role of HFA as a corrective mechanism in corporate governance. Unfortunately, like in the review of defensive measures, the problem the courts have is determining whether the actions taken by the Board are wealth enhancing under the specific facts provided for their review. Therefore, another judicial failure, like the one that occurred with hostile tender offers, may occur if the court takes the path of least resistance and applies its default approach to maximizing shareholder wealth, deference to Board authority. However, empirical evidence showing the value of HFA tells us something else; that such deference no longer needs to be provided when reviewing Board actions that interfere with HFA. If a court's review cannot make adjustments to accommodate HFA, then an opportunity to enhance shareholder wealth will be lost. This potential lack of flexibility under exceptional fact patterns is the judicial failure, a judicial failure that has the potential to shut down HFA like it did

---

110. Easterbrook & Fischel, *Responding to a Tender Offer*, *supra* note 90, at 1201-04. *See also*, Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, *supra* note 113 (arguing that the ability of target companies to auction themselves in response to a hostile tender offer would not be beneficial to shareholders as a whole versus total passivity on the part of the Board).

with hostile tender offers.

This lack of flexibility is demonstrated in the relatively recent court case of *Third Point LLC v. Ruprecht*. In *Third Point*, the court chose the *Unocal* test as its standard of review. The court felt compelled to do so because the *Unocal* test has been Delaware's exclusive standard of review for poison pills since the landmark case of *Moran v. Household International, Inc.*[111] Moreover, "a reviewing court must apply the *Unocal* standard of review whenever a board of directors adopts any defensive measure 'in response to some threat to corporate policy and effectiveness which touches upon issues of control.'"[112] The pertinent facts of *Third Point* are as follows:

At the time when Third Point's accumulation of stock had reached 9.4%, Sotheby's Board adopted a Shareholder Rights Plan (poison pill).[113] The poison pill included an unusual discriminatory trigger.[114] The trigger level would be anything greater than 20% ownership of the company's voting common stock if it involved a passive investor as identified by an SEC Form 13G filing.[115] But the trigger level would only be anything greater than 10% if it involved a hedge fund activist as identified by a Form 13D filing.[116]

Subsequent to the adoption of the poison pill, Third Point amended its Schedule 13D to announce that it was initiating a proxy contest to elect a slate of *three* directors to be voted on at the next annual meeting.[117] Third Point also requested that Sotheby's waive the 10% trigger and allow it to purchase up to a 20% stake in the company.[118] The Board quickly denied the waiver, knowing that the proxy contest was most likely a dead heat and that the waiver would favor Third Point in the vote.[119] The denial of the waiver, the

---

111. Third Point LLC v. Ruprecht, No. 9469-VCP, slip op. at 34 citing Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985).

112. MM Cos. v. Liquid Auto, Inc., 813 A.2d 1118, 1129–30 (Del. 2003) (quoting Gilbert v. El Paso Co., 575 A.2d 1131, 1144 (Del. 1990).

113. Third Point LLC v. Ruprecht, No. 9469-VCP, slip op. at 21.

114. *Id.* at 22.

115. *Id.*

116. *Id.* at 23.

117. *Id.* at 27.

118. *Id.* at 28.

119. *Id.* at 29–31.

decision being reviewed under the *Unocal* test, occurred five months after the rights plan was implemented.[120]

Given the various reasons already discussed, the risk for plaintiffs is that the court will be *overzealous* in its approach to identifying when the activities of HFA are associated with issues of control and therefore creates a "legally cognizable threat" under the *Unocal* test. This is what appears to have happened in *Third Point* when the court found that the "objectively reasonable and legally cognizable threat" that the Board decision was responding to was "negative control,"[121] i.e., obtaining "a controlling influence without paying a premium."[122] According to the Court,

> The evidence currently available indicates that Sotheby's may have had legitimate real-world concerns that enabling individuals or entities, such as Loeb and Third Point, to obtain 20% as opposed to 10% ownership interests in the Company could effectively allow those persons to exercise disproportionate control and influence over major corporate decisions, even if they do not have an explicit veto power. . . .

Moreover,

> If Third Point . . . achieved 20% ownership . . . . that fact, combined with the aggressive and domineering manner in which the evidence suggests Loeb has conducted himself in relation to Sotheby's, provides an adequate basis for legitimate concern that Third Point would be able to exercise influence sufficient to control certain important corporate actions, such as executive recruitment, despite a lack of actual control or an explicit veto power.[123]

This recognition of "negative control" as a legally cognizable threat is troubling. Taking advantage of what the Court calls "negative control" is precisely how HFA benefits the corporate governance of the firm. The activist hedge fund tries to exert as

---

120. *Id.*
121. *Id.*
122. *Id.* at 29.
123. *Id.* at 51–52.

much influence as possible on the Board under the constraint of not having actual control. Even the court acknowledged that significant problems exist with applying negative control under *Unocal*: "The notion of effective, rather than explicit, negative control obviously raises some significant concerns, chief among them being where does one draw the line to ensure that 'effective negative control' does not become a license for corporations to deploy defensive measures unreasonably."[124] Most troubling is that the finding of "negative effective control" in *Third Point* is consistent with the courts traditional permissive approach to the *Unocal* test.

V. General Recommendations on Judicial Review

In the context of judicial review of Board actions taken to mute the activities of activist hedge funds, continued strong deference to Board authority would be a repetition of the mistake made with hostile tender offers and be counter to the objective of shareholder wealth maximization. HFA has a role to play as a corrective mechanism in corporate governance and it is up to the courts to find a way to make sure it continues to have a significant impact despite the courts' inclination to yield to Board authority. In practice, this means that when the plaintiff is an activist hedge fund and the standard of review is the *Unocal* test because issues of control are present, a less permissive approach needs to be applied, requiring the courts to exercise restraint in interpreting the actions of activist hedge funds as an attempt to gain control.

If there are no issues of control, then Board independence and reasonable investigation still needs to be the focus. That is, before the business judgment rule can be applied, the courts need to utilize an enhanced level of scrutiny in determining whether the Board is truly independent of executive management or any other insider such as a fellow Board member. As previously discussed, Board independence is critical to maximizing the value of HFA. Moreover, reasonable investigation of the activist hedge fund's recommendations should be required to justify Board action taken to mute the fund's influence. Like the *Unocal* test, the burden of proof for establishing independence and reasonable investigation needs to

124. *Id.* at 50.

be put on the Board. In sum, what is required in the court's review of Board actions to mute the influence of an activist hedge fund is something similar to the first prong of the *Unocal* test except independence and reasonable investigation is now focused on the Board's evaluation of the fund's recommendations, not the threat to corporate policy and effectiveness.

Fortunately, despite the less than supportive opinion in *Third Point*, an opinion that was published on May 2, 2014, there was still a record 355 activist hedge fund campaigns in 2015 with 127 of those campaigns resulting in at least one board seat for the activist hedge fund, or in the activist having a significant say in the appointment of a new independent director.[125] Nevertheless, given that there are a lot of creative corporate attorneys out there, it is possible that the next Marty Lipton will soon arise and find a creative and powerful new way to mute the activities of activist hedge funds. As time passes, the likelihood of such an event will increase. Therefore, sooner than later, the courts should start looking at the review of Board actions to mute these activities in a new light, before their own precedent ties them into knots and the value of HFA as a corrective mechanism is eventually lost.

---

125. Stephen Foley, *The all-singing, all-dancing activist hedge fund*, Financial Times (January 3, 2016), available at http://www.ft.com/intl/cms/s/0/cbfc05f6-afae-11e5-993b-c425a3d2b65a.html.