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“Hedge Funds in Corporate Governance and Corporate Control”

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Hedge Funds in Corporate Governance and Corporate Control

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Hedge funds seem to be everywhere. One can hardly pick up the Wall Street Journal or the business section of the New York Times without finding at least one story on the growth of hedge funds, how much their managers are making, or their high profile role in one controversy or another. The amount of money flowing into the hedge fund sector has been extraordinary.

In this article, we analyze the role of hedge funds in corporate governance and corporate control. In doing so, we examine the extent to which hedge funds fulfill the long anticipated role of shareholders' champions, and the extent to which their interests diverge from those of shareholders more generally. We also examine the current regulatory structure and inquire whether and to what extent changes are necessary, given our experience to date. Finally, we examine the extent to which firms can protect themselves from hedge fund excesses.

In Part I, we recount some illustrative tales of hedge fund activism that provide grounds for optimism that hedge funds will play the role of activist shareholders who will provide a robust check on managers. Then, in Part II, we examine hedge funds against the backdrop of the analysis of institutional shareholders more generally, and show the ways in which hedge funds' interests are better aligned with those of shareholders than the more traditional institutional investors, such as pension funds, mutual funds, insurance companies and endowments. In Part III, we turn to the dark side of hedge fund activism and focus on those areas in which hedge fund and general shareholder interests diverge. In Part IV, we examine ways in which the dark side is or can be controlled. Finally, in Part V, we draw some more general implications of hedge fund activism on corporate governance and control.¹

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

For decades, the Holy Grail of corporate governance has been the "Shareholders' Champion:" an actor with the incentives and the expertise to protect shareholders' interests in the publicly held firm with widely dispersed ownership. In the 1990s, the hope was that the newly prominent institutional investors – public and private pension funds, mutual funds, insurance companies, and endowments – would play that role.² While, on the whole, the rise of the institutional investors has been beneficial, they have hardly proved to be a silver bullet.

¹ We do not address the question of whether additional regulation is needed to protect hedge fund investors from either investment risk or unscrupulous managers. While important and timely, this question is beyond the scope of this article.

² See, e.g. Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1991); Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Mark J. Roe, *A Political Theory on American Corporate Finance*, 91 COLUM. L. REV. 10 (1991). But see, e.g. Ronald J. Gilson and Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1990); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991).

Are there reasons to think that newly prominent hedge funds will assume the mantle? Have the incentive problems that undermined more traditional institutional investors been solved so that hedge fund managers, in seeking to maximize returns, will check management discretion in the interests of shareholders generally?

In this section, we summarize a variety of promising hedge fund activities with an activist angle. In these incidents, we see hedge funds acting like “real owners”. These anecdotes, which are neither comprehensive nor exhaustive, illustrate the positive potential – the bright side – of hedge fund involvement in corporate governance.

a. Corporate Governance Plus

When dissatisfied with the governance of their portfolio companies, institutional investors have traditionally confined their activism to informal pressure on the board of directors, the introduction and support of precatory shareholder resolutions, or opposition to management proposals. Corporate governance activism by hedge funds, in contrast, is more intense and goes further.

For example, Third Point LLC, a \$2.5 billion hedge fund,³ targeted Star Gas Partners L.P. (“Star Gas”), a heating oil distributor, after acquiring around 6% of Star Gas’ units.⁴ In addition to severely criticizing the CEO, Irik Sevin’s management of the company, Third Point also attacked him personally: “It is time for you to step down from your role as CEO and director so that you can do what you do best: retreat to your waterfront mansion in the Hamptons where you can play tennis and hobnob with your fellow socialites.”⁵ The governance practices of Star Gas were apparently not ideal. Thus, Third Point openly wondered:

[H]ow is it possible that you selected your elderly 78-year-old mom to serve on the Company's Board of Directors and as a full-time employee providing employee and unitholder services? We further wonder under what theory of corporate governance does one's mom sit on a Company board. Should you be found derelict in the performance of your executive duties, as we believe is the case, we do not believe your mom is the right person to fire you from your job. We are concerned that you have placed your greed and desire to supplement your family income - through the director's fees of \$27,000 and your mom's \$199,000 base salary - ahead of the interests of unitholders. We insist that your mom resign immediately from the Company's board of directors.⁶

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⁴ *Third Point Demands That Star Gas CEO, Irik Sevin, Resigns and Returns Keys to Company Car*, PR NEWswire, Feb. 14, 2005, <http://www.prnewswire.com>.

⁵ *Id.*

⁶ *Id.*

The tactic worked. Bowing to the pressure generated by Third Point, Sevin resigned one month later.⁷

Or take Barington, which in June 2003 nominated three directors to the board of Nautica Enterprises, the sportswear company.⁸ At the time, it held about 3.1 percent of Nautica stock.⁹ Shortly thereafter, the company indicated that it was discussing a possible sale.¹⁰ Barington subsequently convinced Institutional Shareholder Services, a proxy voting advisory service, to recommend that its clients vote for the two Barington director nominees.¹¹ By July 2003, Barington's tactics had worked: Nautica agreed to be acquired by VF Corporation for \$587 million¹² and Barington dropped its proxy fight.¹³ The following July, Barington turned to Steven Madden, Ltd., urging it to explore "strategic discussions with potential acquirers."¹⁴ Barington, which had accumulated a 7.7% stake, sent outside directors a strongly worded letter demanding that it hire a more seasoned CEO, reduce change in control compensation, reduce conflicts of interest on the board, and use its excess cash to buy back shares and pay dividends.¹⁵ By February 2005, the Steve Madden board reached an agreement with Barington to avoid a proxy fight.¹⁶ Under the terms of the agreement, the company agreed to spend \$25 million in 2005 for share repurchases and/or dividends, and to meet with representatives of Barington on a regular basis.^{17 18}

⁷ Ron Orol, *Fortress GenCorp*, DAILY DEAL, March 25, 2005, <http://thedeal.com>.

⁸ Suzanne Kapner, *Board Move Lifts Nautica 21 Percent*, N.Y. POST, June 12, 2003, at 41.

⁹ *Id.*

¹⁰ Suzanne Kapner, *Nautica Rises 11% on News of Suitor*, N.Y. POST, June 21, 2003, at 20.

¹¹ *Institutional Shareholder Services Recommends Election of Barington Companies Group Nominees*, PR NEWswire, July 2, 2003, <http://www.prnewswire.com>.

¹² Sundaramoorthy, *Nautica Accepts Dollars 587m VF Bid*, FINANCIAL TIMES, July 8, 2003, at 26.

¹³ *Barington Companies Group Reacts Favorably to Proposed Acquisition of Nautica Enterprises by VF Corporation*, PR NEWswire, July 7, 2003, <http://www.prnewswire.com>.

¹⁴ Tania Padgett, *A Proxy Fight is Brewing for Steven Madden*, NEWSDAY (N.Y.), Dec. 30, 2004, at A45.

¹⁵ *Barington Capital Group Sends Letter to Outside Directors of Steven Madden Ltd.*, PR NEWswire, Dec. 13, 2004, <http://www.prnewswire.com>.

¹⁶ *Steven Madden, Ltd., and the Barington Capital Group Reach Agreement*, PR NEWswire, Feb. 2, 2005, <http://prnewswire.com>.

¹⁷ *Id.*

¹⁸ Similarly, Mario Gabelli, who runs Gabelli Asset Management, has been pushing BKF Capital Group to eliminate its poison pill. Stephen Taub, *Over the Hedge: Mario Gabelli Goes to War with Another Money Management Firm Over a Poison Pill*, DAILY DEAL, July 12, 2002, <http://www.thedeal.com>. He managed to get a non-binding anti-pill resolution passed at the 2002 annual meeting. *Id.* In early 2004, Phillip Goldstein joined the effort. Ron Orol, *Disconnect in Poughkeepsie*, DAILY DEAL, Jan. 19, 2004, <http://www.thedeal.com>. In December 2004, Steel Partners, which acquired 9.3% of the shares, joined Gabelli's effort to eliminate the poison pill, and also asked that the board be "destagger[ed]", and that BKF

b. Litigation

Hedge funds have also developed a niche in taking stakes in companies and then instituting litigation in order to increase the value of their stake. One area where hedge funds pursue this strategy involves statutory appraisal actions. Under corporate law, shareholders who are dissatisfied with the terms of a merger agreement can, in some circumstances, seek a judicial valuation of the value of their shares (“appraisal”) and receive that value instead of the merger consideration. In several instances, hedge funds have bought stakes in companies after the merger was announced and then filed for an appraisal.

Consider, for example, the acquisition of Emerging Communications (ECM) by its majority-shareholder Innovative Communications Corp. The acquisition was structured as a tender offer for \$10.25 per share followed by a cash-out merger at the same price.¹⁹ But Greenlight Capital, a hedge fund, sought appraisal for its 750,300 shares.²⁰ In addition, as common-place in minority freeze-out mergers, a plaintiff’s law firm filed a fiduciary duty action.²¹ These actions are usually settled for a relatively modest recovery (if any).²² Indeed, a settlement, which entailed no additional payments to shareholders, but provided for payment of about \$100,000 in legal fees, was soon proposed. But Greenlight, which had also acquired over 2 million ECM shares, objected to the proposed settlement and the settlement was withdrawn.²³ Both the appraisal and

use its excess cash to increase its dividend and buy back shares. *Steel Partners Asks Board of BKF Capital to Redeem Poison Pill*, PR NEWswire, Dec. 16, 2004, <http://www.prnewswire.com>. In February 2005, Steel Partners upped the stakes and nominated three directors for election at the 2005 annual meeting. *Steel Partners Serves Notice to BKF Capital Group, Inc.*, PR NEWswire, Feb. 14, 2005, <http://www.prnewswire.com>. See also Alan Murray, *Backlash Against CEOs Could Go Too Far*, WALL ST. J., June 13, 2005, at A1 (noting that hedge funds ratcheted up pressure on Morgan Stanley board to remove CEO); Henny Sender, *Hedge Funds: The New Corporate Activists*, WALL ST. J., May 13, 2005, at C1 (noting hedge fund activism at OfficeMax, Woolworths, and Wendy’s).

¹⁹ *In re Emerging Comm., Inc. Shareholders Litig.*, No. 16415, 2004 Del. Ch. LEXIS 70, at *3 (Del. Ch. May 3, 2004, revised June 4, 2004).

²⁰ Greenlight had held shares in ECM before the merger was announced, but increased its stake by 264,700 shares between the announcement and the merger vote. In its 13D filed 10 days later, Greenlight disclosed that it intends to seek appraisal rights. See Greenlight Capital, L.L.C., General Statement of Acquisition of Beneficial Ownership (Form 13D) (Sept. 28, 1998).

²¹ *In re Emerging Communications*, 2004 Del. Ch. LEXIS 70 at *3.

²² See *In re Cox Communications, Shareholders Litig.*, 879 A.2d 604, 622 (Del. Ch. 2005); Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2055 (1995).

²³ *In re Emerging Communications*, 2004 Del. Ch. LEXIS 70 at *3.

the fiduciary duty action proceeded to trial²⁴ – itself a highly unusual event²⁵ - and the court determined that the fair value of an ECM share was \$38.05. Greenlight received that amount, plus compounded interest, on its appraisal shares and it (and the other class members) received \$27.80 – the difference between the fair value and the merger consideration – on the remaining shares.²⁶

c. Blocking Deals

Hedge funds have attracted a lot of attention for their efforts in blocking acquisitions as investors in acquiring as well as target companies.

i. Blocking Acquirers

Most prominently, hedge funds succeeded in blocking the attempt by Deutsche Borse (DB) to acquire the London Stock Exchange (LSE) – even though the acquisition did not require approval of DB’s shareholders. Having tried and failed to acquire LSE in 2000, DB announced a new acquisition bid in December 2004.²⁷ This quickly spurred Euronext, a competing exchange, to announce its interest in LSE.²⁸

Although it was clear that DB’s acquisition of LSE would be controversial, the first hint of opposition from DB’s shareholders came in mid-January when a London-based hedge fund, The Children’s Investment Fund Management (TCI)²⁹, which had assembled more than a 5% stake, announced its opposition. TCI argued that using DB’s cash hoard to buy back shares “would be far superior in value creation.”³⁰ Although the bid did not require shareholder approval, TCI held a large enough stake to call an

²⁴ *Id.* at *4.

²⁵ *In re Cox Communications Shareholders Litig.*, 879 A.2d at 620.

²⁶ *In re Emerging Communications*, 2004 Del. Ch. LEXIS 70 at *155.

²⁷ Norma Cohen, Jeremy Grant & Patrick Jenkins, *LSE in the Bid Spotlight*, FINANCIAL TIMES (London), Dec. 14, 2004, at 23.

²⁸ Norma Cohen, *LSE War Looms as Euronext Confirms Intent*, FINANCIAL TIMES (London), Dec. 21, 2004, at 22.

²⁹ So named because half of TCI’s annual management fee of 1 percent is paid to The Children’s Investment Fund Foundation. Martin Waller, *Fund Says Opposition to Borse’s LSE Bid is Mounting*, TIMES (London), Jan. 18, 2005, at 43.

³⁰ Richard Wray, *Borse Rebel Threatens to Derail LSE Bid: Investor’s Call for Return of Cash May Block German Move*, GUARDIAN (London), Jan. 17, 2005, at 21.

extraordinary general meeting to dismiss DB's supervisory board.³¹ Around the same time, Atticus Capital, a US-based fund which then controlled around 2% of DB's shares, joined TCI in opposing the bid.³² Prompted by TCI and Atticus, by February, DB shareholders holding about 35% of its stock (including several mutual funds) were planning to confront DB.³³ TCI started looking for a candidate to replace Rolf Breuer as DB's chairman, and came up with Lord Jacob Rothschild, who, as it happens, is the father of one of the Atticus partners.³⁴

In early March, DB's CEO Seifert came to London to meet with the largest dissident shareholders.³⁵ They refused.³⁶ With more than 40 or 50% or even 60% of the shares opposing the bid, depending on reports, DB abandoned its bid in early March and promised to develop a plan to distribute the cash.³⁷ In celebrating the victory, the division of labor between hedge funds and traditional institutional investors became clear, "One institution said: 'The hedge funds have done a marvelous job. No matter how we feel about companies, traditional managers simply cannot move as fast to achieve our aims. We were right behind (the hedge funds), but we couldn't have done it without them.'"³⁸ In May 2005, Seifert resigned after having been ordered by the supervisory board "to change the composition of both the supervisory and executive boards in order to reflect the new ownership structure of the company."³⁹

ii. Blocking Targets

³¹ To call a meeting, TCI would have to register its share with BaFin and hold them for 3 months. Damian Reece, *Borse Could Bid Pounds 1.7 bn for LSE, Says Deutsche*, INDEPENDENT (London), Jan. 27, 2005, at 48.

³² Norma Cohen, *Deutsche Borse's 'Empire Building'*, FINANCIAL TIMES (London), Jan. 17, 2005, at 19.

³³ Louise Armitstead, *Shareholders Revolt in Bid to Topple Seifert*, SUNDAY TIMES (London), Feb. 20, 2005, at Business 1; Julia Kollwe, *Fidelity Joins D Borse Shareholder Revolt*, INDEPENDENT (London), Feb. 25, 2005, at 37 (indicating that Fidelity held more than a 4.5 percent stake).

³⁴ Louise Armitstead, *Rothschild to Lead Battle for Borse Rebels*, Sunday Times (London), Feb. 27, 2005, at Business 1; Grant Ringshaw, *Rothschilds Unite in Attack on Seifert*, Sunday Telegraph (London), Feb. 27, 2005 at City 1.

³⁵ FT Global news wire, Mar. 7, 2005 "Deutsche Boerse Bows to the might of Investment Funds"

³⁶ *Id.*

³⁷ *Id.*; Norma Cohen & Patrick Jenkins, *Shareholder Rebellion Puts Paid to Borse Chief's Vision*, FINANCIAL TIMES (London), Mar. 7, 2005, at 30; Danny Fortson, *Deutsche Borse Drops LSE Hunt*, DAILY DEAL, Mar. 8, 2005, <http://www.thedeal.com>,

³⁸ Louise Armitstead, *Saved by the Growing Power of Hedge Funds*, SUNDAY TIMES (London), Mar. 13, 2005, at Business 14.

³⁹ WSJ, May 9, 2005, "Werner Seifert Resigns As Deutsche Boerse CEO," <http://online.wsj.com/article/0,,SB111564686506028205,00.html>.

The controversy over the merger between MONY, a publicly traded life insurance company, and AXA, the large French financial conglomerate, illustrates the attempts of hedge funds to block an acquisition on the target side.⁴⁰ On September 17, 2003, MONY and AXA announced that they had signed a merger agreement (the "Agreement") providing for the payment of \$ 31 cash for each share of MONY.

Hedge funds, including Highfields, Southeastern Asset Management (with 4.9% ownership), Third Avenue Management and Angelo Gordon and Co., (who collectively held around 13.6% of MONY stock) led the charge against shareholder approval of the merger. Highfields took the most prominent role. It asked tough questions in conference calls,⁴¹ sent a nasty letter to management, and ran a full page ad in the Wall Street Journal urging MONY shareholders to reject the merger.⁴² It even mailed a letter to shareholders urging them to vote "no" on the merger and enclosing a duplicate of the corporate proxy card so that shareholders, should they choose, could easily cast a no vote⁴³ and established a website (www.demandfairvalue.com) to aid MONY shareholders in exercising their appraisal rights.⁴⁴ Highfields also convinced Institutional Shareholder Services, the proxy advisory firm, to recommend a "no" vote on the deal.⁴⁵

But this was a deal in which many shareholders had mixed motives. In order to finance its cash acquisition of MONY, AXA had issued a convertible debt security

⁴⁰ For other examples, see Major MCI Holder Starts Proxy Fight to Thwart Verizon, WSJ, 6/15/05 at B3 (noting possible proxy fight by Deephaven Cap. Mgmt. against Verizon-MCI merger); With Rising Clout, Hedge Funds Start to Sway Mergers, WSJ, Jan. 25, 2005, at A1 (reporting several instances where hedge fund interfered with acquisition bids). Mutual funds tend not to engage in similar activities. See Putnam Cites Price in Plan to Vote Against WaMu's Provident Deal, WSJ, Aug. 2, 2005, at C3 (quoting bank analyst as describing public opposition by a mutual fund to acquisition as "a little bit unusual").

⁴¹ Opposition started with nasty questions in MONY group conference calls. Ed Cressler of Angelo, Gordon & Co. asked, "Regarding the \$90 that had been reported in terms of payments to executives as a result of the deal. Just curious about your opinion, given that we're looking at a premium to shareholders somewhere in \$78-79m. Whether or not, do you feel, given the performance of the co., that you actually deserve that payment?" *Event Brief of Q4 2003 The MONY Group Inc. Earnings Conference Call – Final*, FD (FAIR DISCLOSURE) WIRE, Feb. 5, 2004.

⁴² Sara Hansard, *MONY Delays Vote as Dissidents' Effort Gains Steam*; CRAIN COMM., Feb. 23, 2004, at 25.

⁴³ This was the subject of federal court litigation with the issue being whether this constituted an exempt solicitation under Rule 14a-2(b)(1). *Mony Group, Inc. v. Highfields Capital Mgmt., L.P.*, 368 F.3d 138, 141 (2nd Cir. 2004). Highfields won in the District Court, but the decision was reversed by the Second Circuit which held that, under the circumstances, the duplicate management proxy card was a "form of revocation" and thus rendered the solicitation non-exempt. *Id.* at 145.

⁴⁴ PR Newswire, March 31, 2004, Highfields Capital Establishes Web Site for MONY Shareholders Exercising Appraisal Rights.

⁴⁵ Hansard, *supra*, "ISS said the sale price 'is outside the boundary of reasonableness when compared to precedent transactions coupled with open-market opportunities to sell above the offer price.'"

known as “ORANs” to its shareholders. These ORANs were structured to convert into AXA shares on completion of the acquisition. But if the acquisition was not completed by December 21, 2004, the ORANs would be redeemed at face value plus interest at 2.4% per annum. Because the conversion rate was set to be in the money when the ORANs were issued and because AXA’s stock price had further risen, the ORANs would be significantly more valuable if the AXA-MONY deal went through. This appears to have led to a high volume of trading in MONY stock, as holders of ORANs apparently purchased MONY stock at a premium in order to vote for the merger and obtain a large return on their ORAN investment.⁴⁶ At the same time, it seems to have been the case that those short on ORANs were also acquiring MONY shares but to vote against the AXA/MONY merger. Highfields – the hedge fund with nearly 5% of MONY which was leading the charge against the merger – disclosed that it held a large short position in ORANs, a position that would be more valuable if it succeeded in defeating the merger. By contrast, its ally Southeastern Asset Management made much of the fact that it had no position, long or short, in ORANs.⁴⁷ Eventually, after the meeting was moved (which allowed shareholders who had bought after the previous record date to vote) and much litigation, the MONY merger squeaked through, with 53.8% of the outstanding shares voting in favor.⁴⁸

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⁴⁶ In a presentation to the MONY board, “CSFB noted that as of the Board meeting, anyone long ORANs would receive an approximate 46% profit if the merger was consummated, compared to a 2.4% profit if it was not.” Lamb op.

⁴⁷ April 30, 2004 Business Wire, Southeastern Asset Management Demands That AXA/MONY Disclose Information Regarding Arbitrage of AXA Bonds; Reiterates Robert Devlin as Superior Alternative.

⁴⁸ NYT, May 19, 2004, Section C; Column 5; Business/Financial Desk; Pg. 4, Floyd Norris, Holders of MONY Approve \$1.5 Billion Sale to AXA (noting that: Essential to approval may have been a block of 8.7 percent of the shares owned by Deutsche Bank).

⁴⁹ Another striking example is KKR’s December 22, 2004 agreement to acquire Masonite International Corp., a Canadian manufacturer of building products (doors and windows) for C\$40.20 per share (C\$3.1 billion). Toronto Star, Dec 23, 2004 at B01. A February 18, 2005 shareholders meeting was scheduled. Under Canadian law, the transaction required approval by a two-thirds majority of all shares, with at least a majority of the non-management shares. Opposition to the transaction emerged in January. Two large shareholders of Masonite – Eminence Capital in New York (which ultimately owned about 7%) and Regina-based Greystone Management Investments (which ultimately owned just under 10%) – with support from other large shareholders like the Ontario Teachers’ Pension Plan, sought to block the bid. During January, Eminence sent a letter to the board, which it also issued in a press release, which sharply criticized the transaction, and in which it pointed out inconsistencies between the projections used in valuing the company and the projections that had been disclosed publicly, as well as flaws in the valuation methodology used by the special committee’s financial adviser, Merrill Lynch. Canada News Wire, Jan 27, 2005, Eminence Capital Presents Letter to Masonite Board of Directors, available on Lexis. By February 12, the Ontario teachers’ Pension Plan announced that it would vote against the transaction. Toronto Star, Feb 12, 2005, at D20, Teachers’ Opposes Bid by KKR to buy Masonite. On the eve of the February 18 shareholder meeting, in the face of likely defeat, KKR raised its offer by C\$2.05 per share. Toronto Star Feb 19, 2005 at D02 “Door opens with new KKR offer for Masonite”. The main shareholder opponents to the original deal gave their support to the revised offer. Id; The Deal, Feb 21, 2005, Laura King, KKR finally sweetens Masonite Bid. At the March 31, 2005 shareholder meeting, the transaction was approved by a vote of 91.9% of the shares. Canada NewsWire, March 31, 2005, Masonite shareholders approve proposed acquisition by KKR.

d. Making Bids

Unlike traditional institutional investors, hedge funds not only urge portfolio companies to be acquired by others, but have themselves made attempts to acquire these companies.⁵⁰ In some instances, these bids are a part of a strategy to improve the governance or change the capital structure of these companies. In other instances, they have put the target in play, resulting in its acquisition by a third party. Finally, in other instances, hedge funds have emerged as the controlling shareholders of large industrial corporations.

As an example of an acquisition offer that induced corporate governance changes, consider GenCorp, an aerospace and defense contractor that owns more than 12,000 acres of undeveloped land in Sacramento. That holding attracted the interest of various investors including Mario Gabelli (with 12.5%), Steel Partners (with 7.5%), and Pirate Capital (with 2.3%).⁵¹ In November, 2004, Steel Partners announced a willingness to enter into negotiations to acquire GenCorp for \$17 per share.⁵² The board rejected Steel Partner's advance, at which point Steel Partners threatened a proxy contest.⁵³ By February, 2005, the board had entered into an agreement according to which Steel Partners would withdraw a shareholder proposal and cast its votes in favor of GenCorp's nominees in exchange for which: a representative of Steel Partners could attend board meetings; and the board would appoint a new independent director expert in corporate governance who would be identified in consultation with Steel Partners; and the board agreed to then consider the corporate governance changes proposed by Steel Partners.⁵⁴

Next consider Beverly Enterprises, an Arkansas nursing home operator. In January, 2005, a consortium of four hedge and mutual funds – Formation Capital, Appaloosa Management, Franklin Mutual Advisers and Northbrook NBV – made a bid for Beverly.⁵⁵ Within days of announcing the bid, the consortium launched a proxy battle by nominating a full slate of directors to be elected at Beverly's April 21 annual meeting (moved up by the board from the previously scheduled May date) who would be "committed, subject to fiduciary duties, to going forward with a process that would give

⁵⁰ See e.g. Circuit City Rejects Takeover Bid, Won't Consider Any Other Offers, WSJ, Mar. 8, 2005 at A8 (reporting bid by hedge fund Highfields for Circuit City and reporting increasing interest by hedge funds in pursuing takeovers).

⁵¹ Business Week, Jan 24, 2005, at p. 100, Gene Marcial, GenCorp's Earthly Assets.

⁵² PR Newswire, Nov. 11, 2004 "Steel Partners offers to acquire the outstanding shares of GenCorp Inc. in letter to board."

⁵³ Daily Deal, Nov. 16, 2004, Ron Orol, "GenCorp rejects \$700M offer."

⁵⁴ Sacramento Bee, Feb 17, 2005, Dale Kasler, "GenCorp's takeover worries likely not over."

⁵⁵ Daily Deal/The Deal, Jan 27, 2005, Peter Moreira, Four Funds bid for Beverly.

due consideration to [Formation's] offer as well as any other proposals the Company may receive."⁵⁶ Within weeks, and well before the annual meeting, the board agreed to auction the company.⁵⁷ As Chuck Nathan, an M & A lawyer who represented Beverly explained, Beverly saw a "stampede" of hedge funds entering its shareholder base and that, "In two days the entire nature of the shareholder base changed and became majority owned by hedge funds."⁵⁸ Ultimately, after a vigorous auction, Beverley was sold.⁵⁹

Finally, take Kmart. Kmart had filed for bankruptcy in February 2002. When it emerged from Chapter 11 in May, 2003,⁶⁰ its largest shareholder was the hedge fund ESL, run by Edward Lampert. ESL owned about 50% of the company, having acquired \$2 billion in financial claims (for somewhere around \$200 million) which were then converted into stock in the reorganization.⁶¹ At the time it emerged from bankruptcy, the market was skeptical of its chances, with short sellers crowding in.⁶² In May 2003, Kmart's stock opened at \$15 per share and drifted downwards. By July 2004, Kmart's stock was at \$76 per share and Lampert was the toast of the town.⁶³ By unlocking the value of Kmart's real estate through selling off stores, Kmart accumulated a \$2.2 billion "cash hoard."⁶⁴ Business Week asked if he was the next Warren Buffett.⁶⁵ By November 2004, Lampert answered the market's question of what he was going to do with all that money: Kmart and Sears agreed to merge.⁶⁶ ESL had owned a large block of Sears stock since before its investment in Kmart, a block which had increased to 15% by the time the merger was announced.⁶⁷ The news of the deal pushed Kmart stock up to \$109 per share,

⁵⁶ Business Wire, Feb. 4, 2005, Formation capital group nominates slate of independent directors for board of Beverly Enterprises."

⁵⁷ Business Wire, Mar 22, 2005, "Beverly Enterprises board votes to pursue sale of the company."

⁵⁸ Mergers & Acquisitions Report, April 20, 2005, Mark Cecil, "First Quarter M & A: Strongest in Years."

⁵⁹ Cites.

⁶⁰ Which is very quick for a major bankruptcy, and explained by the incentives put in place for management. See Baird & Rasmussen, 56 Stan. L. Rev. 673.

⁶¹ Crain's Detroit Business, May 12, 2003, p. 34: Week in Review; NY Post, May 19, 2003, at 37, Christopher Byron, Short Sell Scramble; Investors are betting that Kmart won't bounce back.

⁶² NY Post, May 19, 2003, at 37, Christopher Byron, Short Sell Scramble; Investors are betting that Kmart won't bounce back.

⁶³ Chicago Tribune, July 11, 2004, C1, Becky Yerak, Exec Lifts Kmart's stock into the blue yonder.

⁶⁴ Business Week, July 12, 2004, at 81, Robert Berner, Turning Kmart into a Cash Cow.

⁶⁵ Business Week, Nov. 22, 2004, cover story, at 144, Robert Berner, The Next Warren Buffett?

⁶⁶ NYT, Nov. 18, 2004 at A1, Constance L. Hays, Kmart takeover of Sears is Set; \$11 billion deal.

⁶⁷ Economist. Com, Nov. 17, 2004, Merger at the mall; Kmart and Sears.

with Sears shares rising as well.⁶⁸ The deal was approved by shareholders in March 2005.⁶⁹

II. Hedge Funds as Institutional Investors

The activism of hedge funds, described in the previous section, dwarfs anything seen from traditional institutional investors. These anecdotes give substance to the hope that hedge funds may act “like real owners” and provide a real check on management discretion. In this Part, we analyze hedge funds against the backdrop of the analysis of traditional institutional investors. Our comparison will focus on the two most important types of traditional institutions: open-ended mutual funds, which hold about 21% of all corporate equities;⁷⁰ public pension funds, which hold about 8% of the corporate equities.⁷¹ We will show that hedge funds share many of the positive structural features of traditional institutions, but that they do not suffer to the same extent from the structural shortcomings of these institutions. As a result, hedge funds are well placed to expend resources on corporate governance activities.

a. Traditional Institutions as Corporate Monitors

The last decades have witnessed a tremendous growth in the shareholdings by institutional investors. According to the Federal Reserve Board, in 1955, 88% of corporate equity securities were held by individuals and 4% by pension funds and by mutual funds. By 1980, the ownership by individuals has declined to 59% and the ownership by pension and mutual funds increased to 21% and 3%. In 1990, individuals owned 50%, while pension funds and mutual funds owned 32% of corporate equity securities. And by 2004, the ownership by individuals has further declined to 38%, with pension and mutual funds also owning 38% of equity holdings.⁷²

⁶⁸ NYT, Nov. 18, 2004 at A1, Constance L. Hays, Kmart takeover of Sears is Set; \$11 billion deal.

⁶⁹ Times (London) Mar. 25, 2005 Business at 51, Sears Investors agree sale to Kmart.

⁷⁰ According to the Flow of Funds accounts, mutual funds in 2004 held \$3697 of \$17204 billion (21%) of corporate equities.

⁷¹ Flow of Funds account. Private pension funds held another 10% of corporate equities. Id. Though some corporate funds are large, many corporate pension funds are relatively small. See Miles (reporting median assets of \$7 million for fully funded plans and of 10 million for underfunded plans). Cf. infra note ____ (average assets of mutual funds are over \$200 million). [We do not further discuss corporate pension funds both they hold fewer assets than mutual fund, because the literature on institutional investors has expressed skepticism about whether corporate funds will be activist, and because corporate funds, unlike public funds, have not been activist.](#)

⁷² Flow of Funds, table L.213, various years.

This trend has given rise, starting in the early 1990s, to a series of articles analyzing the corporate governance implications of institutional shareholdings.⁷³ While a full review of this literature is beyond the scope of this article, it bears pointing out some of its main conclusions.

On the positive side, commentators have noted that institutional investors enjoy significant economies of scale that increases their incentives to monitor their portfolio companies. These economies derive from the fact that, due to their size, institutions tend to hold larger ownership stakes in companies than do individual investors. In addition, institutions tend to hold ownership stakes in numerous companies and are thus sometimes able to spread costs over multiple investments.

On the negative side, commentators have raised several arguments. First, regulatory constraints may affect the ability and incentives of institutions to monitor portfolio companies. Second, institutional money managers suffer from their own conflicts of interest. Third, money managers lack affirmative incentives to monitor: they may be rationally apathetic, as it is often the case that the costs of activism will be greater than the benefits they receive, and they may be particularly prone to engage in free riding on the efforts of other institutions and reluctant to expend resources on corporate governance activities, even if doing so would increase their absolute returns, if such expenditures lower their returns relative to other (free-riding) institutions.

i. The Plus: Size & expertise

Compared to individual investors, traditional institutions enjoy a major advantage as corporate monitor: they tend to be large. The average size of an equity mutual fund was \$218 million in 1990 and \$960 million in 2004.⁷⁴ The largest mutual funds manage assets in the tens of billions of dollars.⁷⁵ In comparison, the average capitalization of stocks in the S&P 500 Index is \$22 billion and of stocks in the S&P MidCap Index is \$2.7 billion. Similarly, the average member of the Council of Institutional Investors, an organization of large public, union and corporate pension funds, has average assets of \$22 billion. Due to their size, traditional institutions enjoy significant economies of scale. These economies of scale arise in two ways. For one, institutions will tend to own a greater number of shares of an individual company than individual investors do. To the extent that monitoring entails company-specific costs, these costs can be spread over a larger investment. Moreover, institutions will tend to own shares in a larger number of companies than individual investors. To the extent that monitoring entails costs that are common for several companies, these costs can be spread over a larger number of investments.

⁷³ [CITES: Rock, Roe, Black.](#)

⁷⁴ 2005 Investment Company Fact Book, tables 3 and 5.

⁷⁵ For example, Vanguard's S&P 500 Index funds has assets of \$84 billion and Washington Mutual Investors Fund has assets of about \$70 billion. CRSP data.

ii. The Minuses: Regulation, Conflicts and Incentive Problems

But traditional institutions also suffer from a number of disadvantages that impede their ability to act as effective monitors. These disadvantages fall into several conceptually-related categories: regulatory constraints, conflicts of interests, and inadequate incentives to monitor.

1. Regulatory Constraints

Traditional institutional investors, in particular mutual funds, are subject to a number of regulatory constraints which are said to affect their ability and incentives to monitor portfolio companies. For one, mutual funds are subject to special disclosure requirements not applicable to other types of investors. Most importantly, mutual funds must supply to their shareholders, and thus to the public, a semi-annual list showing the amounts and values of the securities they own.⁷⁶ In addition, under recently passed legislation, mutual funds must disclose how they voted any shares of their portfolio companies. These requirements make it harder for mutual funds to accumulate positions in portfolio companies without such companies, and the market at large, becoming aware of their activities. As a result, they discourage mutual funds from taking sizeable positions in portfolio companies.

In addition, in order to qualify for significant tax benefits, mutual funds must comply with the diversification requirements in subchapter M of the Internal Revenue Code. Accordingly, 50% of the assets of a mutual are subject to the limitation that the fund may own no more than 10% of the outstanding securities of a portfolio company and that the stock of any portfolio company may not constitute more than 5% of the value of the assets of the fund. Moreover, in order to advertise themselves as “diversified,” – the preferred mode for most funds⁷⁷ -- funds must satisfy as well the diversification requirements of the Investment Company Act. Under the Act, 75% of the assets of a mutual fund are subject to the above limitation that the fund may own no more than 10% of the outstanding securities of a portfolio company and that the stock of any portfolio company may not constitute more than 5% of the value of the assets of the fund. These diversification requirements obviously limit the ability of funds to take large positions in a single company.

Open end mutual funds, by definition and by statute, must stand ready to redeem their shares at the request of any shareholder at short notice.⁷⁸ The redemption price of these shares is based on the fund’s net asset value. These requirements make it difficult for mutual funds to have illiquid investments: illiquid investments cannot be readily

⁷⁶ ICA, section 30(e)(2).

⁷⁷ Roe at 1474.

⁷⁸ [15 U.S.C. §80a-5\(2005\).](#)

transformed into cash when fund shareholders want to redeem their shares and cannot be easily valued. The staff of the SEC therefore issued a guideline limiting the aggregate holdings of a mutual fund in illiquid investments to no more than 15% of the fund's net assets.⁷⁹

Finally, regulations make it difficult for mutual funds to base the fee paid to the fund management company on the performance of the fund. For one, the ability to structure pay-for-performance fee is restricted: Performance fees must be symmetrical, such that if fees are higher than normal after a good year, they must be lower than normal after a bad year.⁸⁰ But even symmetrical pay-for-performance fees are rendered impracticable by the requirement that mutual fund shareholders be permitted to sell shares every day at net asset value. In a good year, existing shareholders would have an incentive to sell their shares (and thus avoid paying the performance fee) right before the fee is payable and other investors would have an incentive to postpone purchases of fund shares until after the fee is payable. This problem could be reduced by basing pay-for-performance fees of shorter performance horizons. But, as the SEC interprets its rules, performance fees must be based on a period of at least one year. As a result, 97% of all funds charge fees based on a flat percentage of the fund's assets – which provides only modest performance incentives – and in the few funds that charge pay-for-performance fees, the percentage fee changes only by modest amounts to discourage strategic withdrawals.⁸¹

2. Conflicts of Interest

Institutional investors also suffer from conflicts of interests between fund managers and fund beneficiaries which inhibit their activities as monitors of portfolio companies.⁸² Consider first public pension funds. Public funds, as a group, have been the most active group of institutions in the corporate governance movement. While many commentators have regarded the involvement of public funds as beneficial,⁸³ others have pointed out that there are strong reasons to doubt that public pension funds will, over the long term, play a beneficial role in corporate governance.⁸⁴ The managers of public funds

⁷⁹ Frankel, vol. 3 at 236 (recommending 10% limit); Supplement at 83 (noting increase to 15%).

⁸⁰ Investment Advisers Act, Section 205. **Hedge fund advisors are exempt by section (c)(7).**

⁸¹ WSJ, 4/14/05 at C1.

⁸² See, generally, Rock, Uncertain. Conflicts are regarded as particularly pronounced in defined benefit plans, where fund assets are usually managed by designated corporate pension fund managers. The managers of a corporate pension fund are appointed by the executives of the corporation that sponsors the pension plan. These executives are believed to pressure pension fund managers to cast pro-management votes. Accordingly, corporate pension funds have not been regarded as likely to become active, and have not become active, in corporate governance. Black at 596.

⁸³ Black at 598-599.

⁸⁴ See Romano, CITE

are either governmental officials or their appointees are elected by pension fund beneficiaries. The former group consists of persons who are or are accountable to politicians and may thus be tempted to pursue political ends, rather than the maximization of investment returns. The latter group has become increasingly dominated by union representatives, who also have objectives that may conflict with the maximization of investment returns. For example, CalPERS, the largest and traditionally most active public pension, has recently come under increasing criticism for the presence of union representatives on its board and the pro-union stance it took in various labor disputes. And Alan Hevesi, the very active New York State Comptroller who is the sole trustee of the \$115 billion New York State Common Retirement Fund,⁸⁵ has been criticized for having the fund hire law firms who made large contributions to his campaign.⁸⁶

Mutual funds also face potential conflicts of interest between the fund managers and the fund beneficiaries. To the extent the mutual fund is affiliated with a financial institution, such as an investment bank or an insurance company, fund managers may be reluctant to antagonize present or future clients with their governance activities. And even companies solely engaged in fund management have potential -- albeit more limited -- conflicts to the extent that their governance activities antagonize companies who have invested or are contemplating investing their pension fund assets with that mutual fund.

3. Incentives to Monitor

Finally, as the classic literature on institutional investors has pointed out, because of rational apathy and free-riding, fund managers may lack affirmative incentives to monitor portfolio companies even when fund investors would benefit from such monitoring.⁸⁷ These incentives are most evident for indexed funds. The job of index fund managers is to replicate the performance of the index. An index fund thus competes with other funds replicating the same index principally on the basis of fund expenses. To the extent that monitoring entails costs, and thus raises the funds' expenses or lowers the fund managers' profits, index fund managers will be reluctant to engage in monitoring.

A similar lack of incentives is generally present for diversified mutual funds. Diversified funds compete on the basis of fees and returns relative to other funds with similar investment objectives. Monitoring will increase a fund's relative returns only to the extent that monitoring both increases the portfolio company's share price *and* that the fund has a higher stake in the portfolio company (relative to the fund size) than competing funds do. For any given portfolio company, this means that funds with a below average stake in the company (relative to fund size) have no incentives, and funds

⁸⁵ <http://www.osc.state.ny.us/pension/index.htm>. (As of December 31, 2003).

⁸⁶ [CITES](#)

⁸⁷ Rock at ____.

with an above average stake have only attenuated incentives to expend resources on monitoring.⁸⁸

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

Table 1

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

The last column of the table indicates the degree to which the Magellan Fund's incentives to monitor are diluted by the fact that any increase in the value of these shares do would not improve the fund's performance relative to the S&P 500 index. As the table shows, the degree of dilution is significant even for the largest holdings of the fund.⁸⁹

The incentive structure for public pension funds is somewhat more complex. To the extent that fund assets are managed by portfolio managers pursuant to match an index – and frequently a large percentage of the fund's assets are so managed⁹⁰ -- the managers will lack incentives to monitor portfolio companies. To the extent that fund assets are managed under a broad diversification policy, the fund managers are presumably evaluated similarly to those of diversified mutual funds and thus suffer from comparable

⁸⁸ And even funds with an above average stake relative to fund size have incentives to expend material resources only if the stake is significant in absolute terms.

⁸⁹ Dilution is likely to be even higher for the fund's other holdings. For example, for the 10 companies in the Magellan Fund's "Consumer Staples" industry group, which account for 7.9% of the fund assets, the weighted average dilution is 78%.

⁹⁰ See e.g., report of NY fund, p 54, indicating that only 27% of domestic portfolio is actively managed.

incentive problems.⁹¹ To the extent that fund assets are invested in a more targeted manner, however, fund managers are likely to have superior incentives to monitor portfolio companies.⁹²

b. Hedge Funds as Corporate Monitors

i. Size

Like traditional institutional investors, hedge funds are pooled investment vehicles run by professional money managers. Since hedge funds are largely unregulated, substantially less data is available about hedge funds than about other institutional investors. However, the available evidence suggests that hedge funds enjoy significant economies of scale. According to estimates, there were approximately 5000 hedge funds in the US with aggregate assets under management of \$480 billion. These figures indicate suggest that the average hedge fund had assets of about \$100 million. The largest hedge funds have assets of about \$10 billion.⁹³ While smaller than the comparable figures for mutual funds and pension funds, these hedge fund figure probably understates the effective assets of hedge funds. Unlike mutual funds and pension funds, hedge funds regularly use leverage and invest in derivatives which enable them to take positions that are much larger than those of mutual funds with similar net assets.

ii. Regulatory Constraints

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

In addition, all institutional investment managers – including hedge fund managers – are subject to the disclosure requirement of section 13(f) of the Exchange Act. Under that provision, a manager who exercises investment discretion over \$100 million or more in registered investment securities must make disclosures about her holdings on a quarterly basis. The disclosure requirements under Section 13(f) differ, however, from those applicable to mutual funds in two important respects. First, an investment manager may request confidential treatment of her filings if **STANDARD**. Second, only holdings of registered equity securities need to be disclosed. Holdings of

⁹¹ See, e.g., report of NY fund, p 54, comparing returns of both total portfolio and actively managed portfolio to returns on Russell 3000 index.

⁹² CalPERS, for example, has about \$550 million (of its \$134 billion portfolio) invested in hedge funds. See Press Release, CalPERS Seeks Advisors ...

⁹³ Institutional Investor Magazine's Alpha Names Farralon Capital Mgmt the World's Largest Hedge Fund Firm in their Annual Hedge Fund 100, PRNewswire, may 27, 2005.

options to purchase such equity securities or holdings of other derivatives need to be disclosed only if such options or derivatives are themselves registered equity securities. As a result of these exceptions, hedge funds can accumulate large economic positions in portfolio companies without disclosures until they become subject to the disclosure requirements under section 13(d).

Hedge funds also have a greater ability to invest in illiquid assets than mutual funds. While mutual funds are required to redeem shares on short notice and SEC guidelines limit the percentage of assets that mutual funds can hold in illiquid investment, hedge funds are not subject to any similar regulatory requirements. Contractually, hedge fund investors have more limited withdrawal rights than mutual fund investor. Traditionally, hedge fund investors could make withdrawals only once every six months. More recently, some hedge funds have moved to curtail withdrawal rights even further.⁹⁴

Hedge funds also have a greater ability to take on debt than mutual funds. Under the Investment Company Act, mutual funds are required to have a three to one asset to debt ratio.⁹⁵ Hedge funds are not similarly limited and, by all accounts, often are far more leveraged.

iii. Conflicts of Interest

Hedge funds suffer from fewer conflicts of interests between fund managers and fund investors than traditional institutional investors. First, hedge fund managers are highly incentivized to maximize the returns to fund investors. The standard hedge fund charges a low base fee equal to 1-2% of the assets under management and a significant incentive fee, typically 20% of the profits earned above a benchmark rate of return. The incentives provided by this fee structure to increase investor returns is likely to swamp any conflicting interests.

Second, hedge fund managers are unlikely to have any significant systematic conflicts of interest. Most hedge funds are independent investment vehicles and are not controlled by any other institution. The main potential conflict for such funds is that their governance activities may antagonize companies who have invested or are contemplating investing their pension fund assets with that mutual fund. But, to our knowledge, neither companies themselves nor pension funds controlled by companies are substantial investors in hedge funds.

To be sure, there are also a few some hedge funds which are affiliated with investment banks. But such affiliations are less common than for mutual funds.

⁹⁴ [See, e.g., Ex-Chairman of S.E.C. Set to Start hedge Fund, NYT, 9/13/05 at C1 \(reporting that investors in new hedge fund can only redeem initial funds after 2 years, and thereafter only annually\).](#) This move may be motivated, in part, by the newly enacted hedge fund advisor registration rules. Under these rules, advisors to funds with a minimum lock-up period of two years remain exempt from registration. See Rule 203(b)(3)-1. The rationale for this exemption is to require registration by hedge fund advisors, but not by advisors to venture capital and LBO funds.

⁹⁵ ICA §18(f), 15 USC 80a-18(f).

Moreover, hedge fund managers are less likely than mutual fund managers to succumb to explicit or implicit pressure from investment bankers to change their monitoring activities because they stand to lose more from doing so. The reasons are multiple. For one, hedge funds tend to hold relatively larger stakes in their portfolio companies than mutual funds. Moreover, hedge fund management firms and managers derive greater benefits from higher hedge fund returns than mutual fund management firms and managers. As a result, even if there were to be a conflict, the conflict is more likely to be resolved in favor of increasing hedge fund profits than in favor of increasing the profits from affiliate activities. Finally, because hedge fund investors tend to be more sophisticated, they may respond more strongly to allegations that hedge fund managers were pressured by investment bankers by withdrawing their funds. Anecdotal evidence confirms that hedge funds do not shy away from taking actions that are antagonistic to investment banking clients of their affiliates. Recently, for example, the Highbridge Fund, majority owned by J.P. Morgan, accumulated a 25+ percent stake in convertible bonds of Saks Inc. and then sent a “notice of default” when Saks breached a covenant by failing to file financial statements with the SEC – even though Saks has an investment banking relationship with J.P. Morgan.⁹⁶ On the whole, therefore, we believe that hedge funds are largely free from conflicts of interests which would impede their activities as monitors of portfolio companies, or at the very least suffer from significantly lower than conflicts than public pension funds and many mutual funds.

iv. Incentives to Monitor

As we discussed above, traditional institutional investors suffer from impaired incentives to monitor portfolio companies due to rational apathy and free riding. Because funds tend to be evaluated based on their performance relative to other comparable funds, even monitoring activities that increase the value of the fund holdings will lead to an improved evaluation only to the extent that the fund’s holdings of a portfolio company exceeds the average holdings in that company by comparable funds.

The incentives to monitor by hedge funds differ in several important respects from those of traditional institutional investors. For one, many hedge funds strive to achieve high absolute returns, rather than returns relative to a benchmark.⁹⁷ These funds may therefore be evaluated based on their absolute performance. But even to the extent that hedge fund performance is evaluated relative to a market index or to other hedge funds with comparable strategies, their incentives are diluted to a less lesser extent than those of mutual funds. The reason is that hedge fund portfolios resemble the relevant market index much less than those of mutual funds. Unlike mutual funds, many hedge funds take significant short positions in companies whose stock price they believe will

⁹⁶ Highbridge Fund Sent Default Note to Retailer Saks, WSJ, 6/20/05 at C5 (the article further suggests that Highbridge bets on Saks stock declining and aims to make money from a short position in Saks).

⁹⁷ Hedge Funds: A Discussion of Risk and Regulatory Engagement, Financial Services Authority (June 2005) at 10.

decline and they tend to take relatively larger long positions in companies whose stock price they believe will increase.

Consider, for example, the stock holdings reported by Caxton Associates, LLC, one of the largest hedge fund advisors, in their 13(f) filings. We performed a similar analysis to the one for the Fidelity Magellan Fund discussed above, comparing the 10 largest stock holdings of Caxton with the holdings in these companies (as of 12/31/04) of the Vanguard 500 Index Fund. The results are reported in the table below.

Company	Caxton (in %)	Vanguard 500 Index (in %)	Difference	Dilution of Caxton's Incentives
Ashland	1.72	0.04	1.68	2.134%
Conseco	2.66	0.00	2.66	0.00
Gillette	4.26	0.39	3.86	9.25%
Guidant	4.45	0.20	4.24	4.57%
May Dept	2.09	0.08	2.02	3.64%
MCI	3.00	0.00	3.00	0.00
Nextel	1.75	0.30	1.45	16.88
Patina Oil	2.72	0.00	2.72	0.00
SPDR	3.84	3.843	0.00	100.00
Western Wireless	2.83	0.00	2.83	0.00
All 10 Stocks	29.32%	4.85%	24.47	16.54% (weighted)

As shown in the table above, even if Caxton's performance is evaluated relative to the S&P 500 index, rather than absolutely, its incentives with respect to its 10 largest holdings would be diluted by a mere 16.5%. Recall that the equivalent percentage for the Fidelity Magellan Fund was 69%.

We caution, however, that Caxton's 13(f) filings only list their investments in publicly-traded equity securities. To the extent that Caxton invests in derivatives or has short positions, these investments are not reported in the 13(f) filings. We consider it likely, however, that inclusion of these other investments would reduce, rather than increase, the calculated percentage dilution and thus that the 16.5% figures represents a high estimate.

Moreover, investors in hedge funds tend to be highly sophisticated. As a result, they may tend to use more complex evaluation criteria which take greater account of the actual success of a fund's monitoring activities. For both of these reasons, hedge funds may be less prone to a free rider problem than traditional institutions.

Most importantly, however, hedge funds suffer less from a free rider problem because their holdings in portfolio companies tend to be more concentrated than those of traditional institutional investors.⁹⁸ In addition, hedge funds may structure their portfolios so that they profit from activism in various ways. As discussed in Part I, for example, it is likely that Highfields stood to profit from a defeat of the MONY – AXA merger both through its holdings on MONY shares and through its holdings of ORANs.⁹⁹ On the plus side, this can allow hedge funds to increase their returns from successful activism thereby overcoming rational apathy or free riding. Although we lack precise data, the available evidence strongly suggests that many hedge funds tend to take significant stakes in portfolio companies, rather than follow a broad diversification strategy common to most mutual and pension funds.

This difference in portfolio composition may be due partly to the lack of regulatory diversification requirements. But we believe it is due mostly to the fact that hedge funds pursue a different business strategy. Mutual funds market themselves as vehicles for diversification and, to a lesser extent, for pooled research and stock picking prowess. They basically spread their investment and then wait (and hope) for the Nile to flood.

Hedge funds put less focus on any diversification benefits and generally pursue more narrowly focused strategies, such as ... **Elaborate.** To balance risk, hedge funds do not diversify, but engage in targeted hedges. Perhaps more importantly, hedge funds have less of a need to balance risk because investors in hedge funds, unlike many investors in mutual fund, are already substantially diversified through their other holdings. Put differently, hedge fund investors have a greater tolerance for risk generated by their hedge fund investment than mutual fund investors have with respect to their mutual fund investment. The reduced need for diversification in conjunction with the more narrowly focused investment strategies enables many hedge funds to pursue a more pro-active strategy for generating returns. Hedge funds are much more likely than traditional institutional investors to take large positions and then some action -- often at a significant expense -- that increases the value of that position, rather than waiting passively for excess returns to arrive.

v. Concluding Remarks

Hedge funds differ from traditional institutional investors in several ways that bears on their abilities and incentives to engage in monitoring: they tend to be smaller, have more concentrated and targeted investments, suffer from fewer conflicts of interest, and have superior incentives to monitor. As a result of these differences, monitoring activities by hedge funds are likely to differ from those of traditional institutions.

In particular, hedge funds will be more likely to engage in monitoring related to issues that are specific to individual companies, such as whether Deutsche Borse should

⁹⁸ Cites. [Refer to anecdotes. Back up with interviews. See also WSJ article on fund holding \\$8 billion of certain treasuries.](#)

⁹⁹ See supra TAN.

acquire the London Stock Exchange or whether shareholders of Emerging Communications should exercise their appraisal rights. Hedge funds have incentives to engage in such monitoring because it comports with concentrated holdings and a targeted investment strategy, whereas traditional institutions may shy away from such monitoring because of the conflicts or incentives problems discussed above.

In contrast, hedge funds will be less likely to engage in monitoring related to issues that affect a large number of companies similarly, such as, according to some commentators, whether companies should adopt a staggered board.¹⁰⁰ With respect to such factors, the larger economies of scale enjoyed by traditional institutions due to their larger size are likely to outweigh any monitoring advantages enjoyed by hedge funds. Thus, we would not expect (and in fact do not observe) hedge running general campaigns against poison pills or proposing precatory resolutions in large number of portfolio companies – activities in which traditional institutions have regularly engaged in.

III. The Dark Side: When Hedge Fund and Shareholder Interests Diverge

Although, as we describe above, hedge funds hold great promise as active shareholders, there are also plausible scenarios that raise concerns. In this section, we identify several ways in which hedge fund interests diverge from those of other shareholders and the extent to which that divergence is constrained by existing regulation.¹⁰¹

Hedge funds, like mutual funds and pension funds, are set up to make money for their investors without regard to whether the strategies they follow benefit shareholders generally. As a result, while there will be occasions when there is a coincidence of interests, there will also be occasions when the interests diverge. But because of the particular investment strategies hedge funds use – specifically their high trading frequency and use of sophisticated trading strategies, their investment in derivatives, and their focus on hedging and arbitrage – divergences in interest are likely to be more common than for regular institutions. Consider the following scenarios, each of which is currently possible and, at least according to some reports, each of which has been used.

a. Empty Voting¹⁰²

¹⁰⁰ Black, Bebchuk, but see Kahan & Rock.

¹⁰¹ We do not concern ourselves with the extent to which the interests of hedge fund managers may diverge from the interest of hedge fund investors, or what to do about any such divergence. Although an important question, it is beyond the scope of this Article.

¹⁰² The issues relating to empty voting are extensively discussed in Martin & Partnoy and Black & Hu. Our approach differs in ways which we highlight below.

Mylan Laboratories entered into a merger agreement with King Pharmaceutical, according to which, and subject to shareholder approval, Mylan would acquire King for Mylan shares. Perry Corp., a \$__ billion hedge fund, was a large shareholder in King (approximately 7 million shares) and supported the merger.

The claim, made by Carl Icahn (a large holder of Mylan who opposed the merger) and based on Perry's SEC filings, is that Perry acquired 9.9% of Mylan at the same time as he entered into "equity swaps" with Bear Stearns and Goldman Sachs which fully hedged his economic exposure to Mylan's share price. Thus, according to the complaint, Perry acquired shares, and thus votes, in Mylan, which, because he had no economic stake in Mylan, he could vote purely on the basis of his interest as a King shareholder.

Perry's fully hedged acquisition of shares in Mylan is an example of a more general set of strategies for obtaining the right to vote shares without bearing economic risk that Black & Hu have termed "empty voting."¹⁰³ Consider the following scenarios.

First, HF can buy a block of Firm X and, at the same time, enters into an equity swap.¹⁰⁴ In a typical equity swap, one party agrees to pay the return on a particular stock (or a stock index), in exchange for the other party paying a fixed or floating rate on a fixed principal amount.¹⁰⁵ HF thus divests itself of the economic risk in X (with the gains/losses from its stake in X and the losses/gains from the swap canceling each other out)¹⁰⁶ but can vote the shares in favor of the merger because it is the record owner of the shares. After the vote, HF unwinds the position by selling its shares and ending the equity swap.

Second, HF can buy a block of Firm X before the record date, sell a call option on the shares and use the proceeds to offset the cost of a put option (a "zero-cost" collar).¹⁰⁷

¹⁰³ Black & Hu.

¹⁰⁴ A swap contract is a contractual arrangement between two parties in which the parties exchange agreed upon cash flows at specified intervals. For a comprehensive discussions of equity swaps, see: Charles W. Smithson, *Managing Financial Risk* (McGraw Hill, 1998), Ch. 8, 9; Robert W. Kolb, *Futures, Options and Swaps* (th Ed. 2002) Ch. 20; see Joel Morse, Robert Nash, Jack Clark Francis and Sanjay Nawalkha, *Equity Swaps: Motivations and Applications*, in Timothy Haight, *Derivatives Risk Management Service* (Warren Gorham & Lamont, 1996) at Ch. 3C.

¹⁰⁵ Equity swaps are typically arranged by broker dealers who, if they wish to protect themselves against risk, can do so by shorting the shares of X. Bettis, Bizjak, and Lemmon, managerial ownership, incentive contracting and the use of zero-cost collars and equity swaps by corporate insiders, 36 J. Financial and Quantitative Analysis, 345-70 (Sept. 2001).

¹⁰⁶ The only risk that HF retains is counterparty risk (easily controlled by dealing with a well capitalized counterparty) and the risk that the contract is poorly crafted so that it does not adequately track whatever index is chosen (again easily controlled).

¹⁰⁷ Bettis, Bizjak, and Lemmon, managerial ownership, incentive contracting and the use of zero-cost collars and equity swaps by corporate insiders, 36 J. Financial and Quantitative Analysis, 345-70 (Sept. 2001). Zero-cost collars, which are widely used by insiders, clearly pose severe problems in the use of stock, options or other incentive compensation. David Schizer, *Executives and Hedging: The Fragile Legal*

The market for such collars has grown and, by all accounts, they are readily available. Together, the put and call options eliminate as much of the economic risk as HF chooses to off-load. The cost to HF is the difference, if any, between the cost of the put option and the proceeds of the call option.

Third, HF can buy a block of Firm X before the record date and, at the same time, short the same amount of Firm X's stock in order to divest itself of economic risk.¹⁰⁸ HF votes the shares for the merger.¹⁰⁹ Subsequently, HF unwinds the position by closing out the short position by delivering shares to the lender.

Finally, X can buy shares before the record date and sell them immediately after the record date,¹¹⁰ obtaining the right to vote the shares¹¹¹ but bearing the economic risk of its ownership of X stock only for the short time interval surrounding the record date.

The divergence between the interests of the HF and those of these other shareholders is obvious here: having divested itself of all economic risk in firm X, HF will vote its shares of X according to what advances its interests as a shareholder in firm Y. In this transaction, the interests of the shareholders of Firm X and Y directly opposed: If Firm X entered into a merger agreement that offered an excessive price for Y, shareholders of X would benefit from rejecting the agreement but Y shareholders would benefit from an approval by X.

As will be discussed in more detail in section 4, current law hardly interferes with these strategies. Whether it can or should is a tricky question that we discuss below, and which requires close attention to the ease with which one can switch among these various strategies.

Foundation of Incentive Compatibility, 100 Colum. L. Rev. 440 (2000). Zero-cost collars have become a popular product, especially as a means of allowing insiders to hedge themselves against risk on their holdings in their company. *Id.*

¹⁰⁸ HF shorts the stock of X by borrowing a share in order to sell it. Brokerage houses typically arrange for a short seller to borrow shares from a custodian bank which holds shares (in a fungible mass) for its custodial clients such as mutual funds, pension funds and insurance companies. The short seller must provide collateral (typically cash) equal to 102% of the value of the shares, with some portion of the interest on the collateral rebated. The cost of borrowing a share is the difference between the market overnight interest rate and the amount rebated. Christopher C. Geczy, David K. Musto, and Adam Reed, *Stocks are Special Too: An analysis of the equity lending market*, 66 J. Fin. Econ. 66 (2002) 241-69.

¹⁰⁹ Under current law and practice, HF retains full voting rights: HF has the voting rights for the shares that it owns; and it only "borrowed" the (different) shares that it sold to divest itself of economic risk.

¹¹⁰ One well known and common use of this strategy is to arbitrage different tax treatments of dividends.. There is a substantial literature on the cost effectiveness of the strategy. Christoffersen, Geczy, Muso and Reed, *The Market for Record Date Ownership*, working paper 2002.

¹¹¹ Who gets to vote a share, like who is entitled to dividends on that share, is determined by who owns the share on the record date. Del GCL §213.

b. Manipulating Trigger Prices

Private placements of securities have certain advantages and disadvantages to firms raising capital. But private placements have less liquidity than public offerings and investors require a discount to compensate them for the illiquidity (including the risk that the value of the firm will drop between the time that the shares are bought and the time when they can be sold). One security combining the speed of a private placement with a commitment by the issuer to file a registration statement within a short period of time are convertible PIPEs (private investments in public equity). Although rare today, a few years ago convertible PIPEs were more common. Some PIPEs included a floating conversion rate according to which the conversion into common stock would be at a discount not only to the price of the stock at the time the PIPE was issued but also at a discount to the price of the common stock at the time the PIPEs were subsequently registered. This was done by issuing PIPEs with a conversion ratio set with reference to the share price at issuance and then reset at the time the shelf registration became effective. It is this latter provision that caused difficulties.

The conversion rate reset provided an incentive for PIPE holders to short the common stock of the issuer to drive down the market price at the time the conversion price was reset, thereby increasing the number of shares into which the PIPEs became convertible. And, of course, where there is such an opportunity, clever money will exploit it. Thus, for example, Angelo Gordon & Co. and Citadel – two hedge funds prominent in current M & A activity – invested in these convertible PIPEs and apparently took advantage of the opportunities presented.¹¹² A slew of lawsuits were filed.¹¹³ Since this toxic potential of PIPEs has become clear, they have largely disappeared.

The reset provisions in the PIPEs illustrate just one possibility when a contractual provision in one security makes its value depend on the market price of another security and which, as a result, provides an opportunity for arbitrage.

¹¹² FN: CFO Magazine, November 2004, The PIPEs Are Flowing, Ronald Fink (Angelo Gordon and Co. invested in such PIPEs issued by eToys).

¹¹³ Lawsuits filed in the Second and Third Circuits alleged “manipulation” in violation of Sections 9 and 10(b) of the 1934 Act in these sorts of cases. Because of the limitation of claims under section 9 to “classical” market manipulation, section 10(b) has provided a more promising route. Under both the Second and Third circuit standards, a claim for manipulation in toxic convertibles can be stated; *LOG ON AMERICA, INC., v. PROMETHEAN ASSET MANAGEMENT L.L.C., HFTP INVESTMENT L.L.C., FISHER CAPITAL LTD., WINGATE CAPITAL LTD., CITADEL LIMITED PARTNERSHIP, AND MARSHALL CAPITAL MANAGEMENT, INC.* 223 F. Supp. 2d 435 (SDNY 2001) (dismissed on the pleadings: the PIPEs agreement specifically permitted the purchasers to sell the issuer’s stock short). Zachary T. Knepper, *FUTURE-PRICED CONVERTIBLE SECURITIES AND THE OUTLOOK FOR “DEATH SPIRAL” SECURITIES-FRAUD LITIGATION*, 26 Whittier L. Rev. 359 (2004); Leib M. Lerner, *Disclosing Toxic Pipes: Why the SEC Can and Should Expand the Reporting Requirements Surrounding Private Investments in Public Equities*, 58 Bus. Law. 655 (Feb. 2003).; Deepa Nayini, *Comment: The Toxic Convertible: Establishing Manipulation in the Wake of Short Sales*, 54 Emory L. J. 721 (2005). For a detailed analysis of the cases, see Nayini.

c. Buying Hedge Fund Acquiescence

HF acquires a stake in Firm X. Firm X and Firm Y decide that they want to merge, a merger which HF does not believe is in the best interests of Firm X. HF threatens to oppose the merger, to vote against it, and to urge other X shareholders to vote against it. Management of X and Y would like to convince HF not to campaign against the merger. X and Y agree that HF will dissent from the merger, file an appraisal action which will subsequently be settled by the surviving corporation for a premium above the merger consideration.

d. Market Timing

Hedge funds have also been prominent in the recent scandals involving late trading and market timing in mutual fund shares. Investors can buy or sell shares of open end mutual funds on any day at their “net asset value” which is usually based on the closing market prices of the securities held by the mutual funds. Late trading or market timing essentially involves buying or selling mutual fund shares when that net asset value reflects closing market prices which are stale because prices have moved since the market close. Late trading, which is illegal, involves investors placing buy or sell order in mutual funds after the close of the U.S. markets. Market timing, which is not illegal, takes advantage of the fact that, due to international time differences, securities market abroad close before U.S. markets do and that the “closing market prices” of securities traded abroad may become stale before the close of the U.S. markets. Mutual funds have sought to restrict market timing in various ways, including using fair value pricing rather than closing market prices when appropriate and restricting investors from rapid in-and-out trades. In both late trading and market timing, the profits of the trading investors come out of the pockets of other, non-trading holders of the mutual fund.

The late trading/market timing scandals broke in [date] when New York’s attorney general Eliot Spitzer uncovered evidence that hedge fund Canary Capital Partners had engaged in these activities.¹¹⁴ Subsequent events indicate that late trading and market timing were more wide-spread.¹¹⁵ Though hedge funds were not the only investors who engaged in these activities, they seemed to have been the most active ones. Thus, hedge funds have allegedly been involved in late trading or market timing in funds managed by Alliance Capital, Bank of America, Banc One, Canadian Imperial Bank of Commerce, Conseco, Pilgrim Baxter and PIMCO.¹¹⁶ In some instance, the mutual fund management company acquiesced, or even encouraged, these activities, often violating

¹¹⁴ Cite

¹¹⁵ See Barry P. Barbash, *The Post-Canary Fund Regulatory Deluge*, 1483 *PLI/Corp.* 639 (2005) (presenting overview of allegations)

¹¹⁶ *Id.*

their own stated policies. In others, hedge funds, with the assistance of brokers, evaded the safeguards the funds had instituted to prevent them.¹¹⁷

e. Pumping and Dumping

Temple-Inland is an Austin, Texas based packaging, paper and finance company. As of the beginning of February, 2005, it was trading at around \$64 per share. In early February, 2005, Carl Icahn (one of the 1980's high profile corporate raiders who now runs a hedge fund) requested antitrust clearance to acquire up to \$1 billion (24%) of the company's stock.¹¹⁸ Icahn's interest, and reputation, instantly pushed the stock up 16%.¹¹⁹ Analysts viewed Icahn's interest as a sign that Temple-Inland would soon be splitting up.¹²⁰ On February 15, Icahn announced his intention to nominate his own slate of directors.¹²¹ At the same time, Icahn and his related entities indicated that they already owned about 2 percent of the stock, without any indication of their cost in acquiring it.¹²² The price continued to rise, hitting its peak in early March of \$84 per share (adjusting for a 2-1 stock split).

Then, on March 24, Icahn announced that he would not nominate a slate of directors after all.¹²³ The stock dropped 9% following the announcement, and continued to slide.¹²⁴ By the end of March, according to a May 2005 filing, Icahn had disposed of his entire stake, although the timing and the price at which he sold his shares was not indicated.¹²⁵ The stock price then returned to more or less where it was before Icahn first indicated his interest in February.

f. The Grey Zone:

i. Hedge Funds as Short Term Investors

¹¹⁷ Id.

¹¹⁸ Renuka Rayasam, Icahn has his eyes on Austin company: Corporate raider is planning to buy up to 24% of Temple-Inland, Austin American Statesman, Feb 5, 2005 at A1.

¹¹⁹ Id.

¹²⁰ Vipal Monga, Temple-Inland gets Icahn push, Daily Deal, Feb 7, 2005.

¹²¹ Padraic Cassidy, Wall Street Likes Icahn's Temple-Inland break up Plan, CBS MarketWatch Feb. 18, 2005.

¹²² Id.

¹²³ Renuka Rayasam, No Icahn directors for Austin Company, Austin American-Statesman, March 25, 2005 at E1.

¹²⁴ Id.

¹²⁵ Icahn lets go of stake in Austin company, Austin American Statesman, May 14, 2005 at F1.

Hedge funds come close to the archtypical short-term investor. While there are surely differences among hedge funds, their high relative trading volume – they account for one-third to one-half of daily trading activity, but only for 5% of total assets – and their frequent use of derivatives which often are inherently short term financial instruments -- indicates that hedge funds are primarily oriented to investments with relatively short-term payoffs. Thus, apart from the specific conflicts of interest identified above, there is a possible divergence between the “short term” interests or incentives of hedge funds and the “long term” interests of diversified shareholders in maximizing the value of the firm. Whether and under what circumstances there can be a conflict between short-term and long-term investors has been the subject of voluminous analysis and debate. Without reviewing this debate here, and without taking a position on it, it suffices to say that, at least in certain circumstances, there is the theoretical possibility for such a divergence and that some prominent commentators believe that such a divergence is actually significant.

Divergence between short-term and long-term shareholders generates what we call a “grey side” for hedge funds. Even if they are short-term oriented, hedge fund may perform valuable functions. For example, when hedge funds are playing their traditional role of arbitraging market inefficiencies, their pursuit of short-term profit will be one of the mechanisms that helps to bring the market price into alignment with the value of the firm. Thus, for example, when prices are too high because of excessive optimism, hedge funds can be expected to short the stock thereby putting some necessary downward pressure on the price. Moreover, even if the interests of short-term and long-term investors may occasionally conflict, their interests will often coincide. To that extent, hedge funds, by furthering their own short-term interests, will also benefit long-term shareholders.

On the other hand, hedge funds with a short term focus may benefit by pressuring managers to abandon higher (but hard to) value projects in favor of more easily valued projects. This pressure will injure the interests of the long term shareholders who are relatively indifferent to short term fluctuations in stock price so long as the market accurately values the assets over the long term.

The difficulty, of course, is in identifying actual examples of each type. Consider, in this regard, the DB case. DB’s CEO wanted to acquire the LSE and convinced the board that doing so was a good idea. A number of hedge funds who had acquired large stakes in DB disagreed. They maintained that the plan to acquire the LSE represented wasteful managerial empire building and that DB’s cash hoard should instead be distributed to shareholders. Now, if the investment in acquiring the LSE is one of those hard to value projects whose value will only subsequently be recognized, then the dominance of the hedge funds has had the effect of pushing the company towards the lower value outcome, an outcome worse for long-term shareholders than acquiring the LSE. By contrast, of course, it may be that the hedge funds are right that the investment was simply a bad investment driving by delusions of grandeur. In that case, the hedge fund opposition saved the shareholders from loss.

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

ii. Buying (control) v. Selling (shares)

As the earlier anecdotes show, hedge funds are sometimes buyers not sellers: Lampert acquired control of Kmart in bankruptcy; Cerberus has been competing with private equity funds in auctions; a group of funds made a bid for Beverley combined with a proxy fight. When hedge funds are buyers, their interests clearly and obviously diverge from those of the other shareholders: the hedge fund wants to buy at the lowest possible price while the other shareholders want to sell at the highest possible price. Moreover, hedge fund activities may not be so much directed at making sure that the target is sold at the highest price, but rather that to increase the likelihood that the hedge fund succeeds in its acquisition attempt. On the other hand, hedge funds will rarely control the target's activities, the conflict of interest is disclosed and well-known, and target shareholders and managers are likely to be able to take account of it. And to the extent that hedge fund attempts to buy control represent mere offers that target are free to accept and reject, they are likely to benefit target shareholders. Because of these ambiguities, we place these activities in the grey zone.

IV. Responding to the “Dark Side” of Hedge Fund Activism without Dimming the Bright Side?

As the previous discussion indicates, HFs hold great promise at the same time as they pose certain dangers. In this section, we discuss what, if anything, can and should be done to control the dark side of hedge fund involvement.

From the earlier discussion, we can identify three sources of difficulty. First, hedge funds, with their highly incentivized structure, will put stress on the system as they focus on detecting and exploiting imperfections. Second, in certain circumstances, they face straightforward conflicts of interest. Third, and most interestingly, is the blurring of the line between risk arbitrage and battles for control: when risk arbitrageurs gain the power to determine the outcome of a contest, the nature of the activity is transformed.

Hedge funds specialize in detecting and exploiting imperfections. In their ordinary trading activities, hedge funds seek to exploit imperfections in the market pricing of securities or to arbitrage price differences between different markets. When hedge funds become active in corporate governance, they seek to exploit imperfections in the way the firm is run in order to increase the share price. What is peculiar about hedge funds is that it is economical for them to detect new imperfections or to exploit smaller imperfections than institutional investors.

When hedge funds engage in “dark side” activism, they also exploit imperfections. Typically, dark side activism will involve, to some extent, the exploitation of imperfections in the legal or contractual structure. Thus, for example, empty voting exploits imperfections in the ordinary rules on voting rights. The ordinary rules on voting are based on the premise that voting rights should go along with an economic stake in the firm, with a share of stock representing both. Empty voting exploits the fact that the ordinary rules do not take account of the ability of investors to own shares but divest themselves from the economic interest that these shares represent. Similarly, triggers are based on the premise that the trading prices used as triggers represent fair market values of the underlying securities. Manipulating trigger prices exploits the fact that the contracts incorporating trigger prices (and the legal rules on manipulation) are imperfectly designed and thus permit the possibility that investors can cause temporary deviation between trading prices and fair market values. Redemption rules for mutual funds rest on the premise that redemption prices based on end-of-day market values represent the fair value of the mutual fund shares. Market timing exploits imperfections in these pricing regimes and imperfections in the legal regime and the various strategies employed by mutual funds to limit market timing.

Further complicating the analysis is the ability of hedge funds to both bet on the outcome of an uncertain contest (classic risk arbitrage) and affect the outcome of that contest. There are numerous examples of hedge funds taking stakes whose value depends on firm actions (e.g. Mylan-King and AXA MONY), and then taking action – everything from lobbying to bids to acquiring shares for their votes while hedging economic risk – to determine the outcome. Risk arbitrage, which is normally socially valuable because it provides liquidity and makes stock prices more accurate, may have different effects when the outcome is not exogenously determined. One hopes, for example, that the MONY shareholder vote on whether MONY should accept the AXA offer was not ultimately decided based on the spread between MONY shares and AXA’s ORAN securities issued to finance its bid, although that may well have happened.

As dark side activism exploits imperfections in the legal and contractual structure, it results in additional strains. Imperfections that may have been tolerable in the absence of such activism – because they were not recognized or because, albeit recognized, they were not systematically exploited – can become intolerable or at least more costly to tolerate. Moreover, unlike say imperfections in market prices which are automatically eliminated by the very activities designed to exploit such imperfections, dark side activism does not by itself eliminate imperfections in the legal and contractual structure.

There are three general categories of potential responses. We can: rely on market forces (e.g. competition among hedge funds, reputation); rely on self-help (charter amendments, contracts); or rely on regulation. While the specific response obviously depends on the specific nature of the dark side activism, it is critical to bear in mind that dark side activism is not static. The dark side strategies we described in the last section are likely to change. Hedge funds are among the most nimble market actors, with a track record of coming up with new strategies, some of which are designed to exploit imperfections in the very responses developed to the old strategies. Moreover, hedge funds are not only clever, but quick. So in choosing a mode of response, speed and flexibility are very important. This suggests that the market forces and self-help are better designed to deal with hedge fund dark sides than regulation is. The reason is two-fold. For one, private actors can generally react more quickly than regulators. Second, private actors have a greater ability to learn from each other in devising a proper response.

There is yet another important dimension: new problems versus old problems. As we'll discuss below, some of the problems emerging are examples of classic corporate issues. When that is the case, the relevant question is whether the specific characteristics of hedge funds put sufficient pressure on the system that the traditional (albeit imperfect) remedies are no longer adequate. Other problems, such as empty voting, seem to be new problems that corporate law has not addressed.

a. Old-style Problems

Many of the problems identified earlier are familiar corporate law problems. For these issues, the question is whether the traditional solutions are adequate to the task, given the increased pressure applied by hedge funds. Because these problems are well known in the literature, our discussion will be brief, with our focus on the impact of the special characteristics of hedge funds.

Manipulating Trigger Prices: The issues presented by toxic PIPES and use of collars in stock for stock mergers are rather interesting and complex examples of contracting malfunction between sophisticated parties. Hedge funds magnify the effects of relatively trivial mistakes because of their ability to exploit even small arbitrage opportunities, as well as by their sophistication in trading. But their sophistication is well known. Whatever the appropriate resolution in particular cases,¹²⁶ the ultimate solution is in the hands of issuers and their lawyers. If issuers want to prevent investors in private placements from shorting their shares, they can include a provision prohibiting or limiting short activity. Alternatively, they can restrict the adjustment to the later conversion ratios. Or they can avoid these kinds of securities altogether, and rely on plain vanilla equity and debt.¹²⁷ While the experience with toxic PIPES should teach

¹²⁶ See Nayini, Emory note.

¹²⁷ Even when used, they were only used by firms with no other options. Paul Elias, *Death by Finance*, Red Herring, April 1, 2001 at 46.

issuers to think through in advance how hyper incentivized, devilishly clever traders will take advantage of profitable opportunities, the presence of such investors (who have never, of course, been absent) provides little reason to change the regulatory structure more broadly.

Late Trading/Market Timing: The late trading and market timing scandals represent, in a sense, a hedge fund induced twist on a familiar problem. That is why late trading is illegal, and why many funds openly discouraged market timing. The main problem with late trading and market timing is one of enforcement: in late trading, the enforcement of the rule prohibiting it; in market timing, the compliance by funds with their stated self-imposed policies against market timing. Even in the instances where market timing occurred without at least the acquiescence of the mutual fund, it appears that brokers assisted the perpetrators in violation of yet other rules. What hedge funds did was exploit the lax enforcement regime by the S.E.C. until Eliot Spitzer, the Attorney General of New York, found yet another occasion to upstage his regulatory nemesis.

“Pumping and Dumping”: The situation illustrated by Icahn’s trading profits in the Temple-Inland situation presents a more complex problem, but also not new. To the extent that, in the Temple-Inland situation, Icahn took advantage of his reputation for shaking things up to cash in while the price was inflated by the expectation that a change of control was likely, his opportunities are self limiting. If he does this too frequently, he will lose his credibility as a threat. Moreover, because his interest in a target is disclosed, investors are on notice that any increase in stock price that is a result of Icahn’s interest can disappear if he loses interest. Moreover, current rules already prohibit Icahn from making materially false statements in relation to the purchase or sale of securities. Thus, if Icahn’s interest in Temple-Inland had been a charade – if he never intended to acquire a large stake or to nominate a competing slate of directors – his public disclosures would likely have run afoul of Rule 10b-5.

b. Grey Zone Problems

“Short-termism”: As noted above, the claim that “short termism” by certain shareholders interferes with optimal investment has long been made and discussed. The rise of hedge funds perhaps highlights the concern, but so did the rise of hostile takeover in the early 1980s and of proxy fights in the 1960s. Because of the uncertainty of whether there is a real problem, much less what to do about it, there is no plausible regulatory intervention that seems likely to do more good than harm. The kinds of direct interventions that have been proposed in the past – for example, a tax on securities transactions to discourage “excessive trading” – are generally conceded to be bad ideas. Moreover, there are indirect ways that firms can choose to protect themselves if they are concerned about heightened short-termism. Thus, for example, a staggered board will provide some degree of insulation from short term pressures. Or firms may pursue strategies designed to attract a particular investor clientele.¹²⁸ More generally, as we

¹²⁸ See, e.g., Berkshire Hathaway’s refusal to split its stock as an example. CITE.

have elaborated elsewhere, we would regard the possible problem of short-termism generated by hedge-funds as the sort of problem that is optimally addressed by adaptive responses:

“Buying Control”: While, as noted above, it is clearly true that hedge funds’ interests diverge from general shareholder interests when they are seeking to buy control, this conflict is both obvious, and sufficiently similar to the issues raised by any bid for control, that no special response is necessary.

c. The Cutting Edge: Empty Voting

As we have seen, the issue of empty-voting is highly complex.¹²⁹ This complexity arises from the fact that multiple mechanisms can generate empty votes, that current legal rules do not treat these mechanisms equivalently, and that at present, neither the market, nor companies, nor regulators have the information necessary to determine the presence and extent of empty voting schemes. The development of a proper response is made even more complicated by the fact that companies and investors have an interest in determining the outcome of a vote speedily. Thus, any more intrusive legal regime that involves protracted litigation generates special problem in the context of voting rules.

i. Current Legal Treatment

Let us consider the empty voting schemes described in Section 3 more closely. To generate empty votes, each scheme employs one (or both) of two strategies. The first strategy involves the ownership of shares – which entail both voting rights and represent an economic stake – and the use of derivatives to divest the economic risk while retaining the voting rights. The second strategy involves the notion of a record date. Because shares are constantly trading hands, especially in publicly held corporations, companies need to fix a time to determine which shareholders are entitled to vote, or to receive dividends. Moreover, that time must be set far enough in advance of the meeting to allow for the distribution of proxy materials and the casting of votes by record shareholders.

Against that backdrop, the first three strategies all use derivatives. In the first strategy, HF purchases shares in X and enters into an equity swap to divest economic risk. The second involves a purchase of shares, a sale of a call option and the purchase of a put option (“zero-cost collar”). The third involves a purchase of shares and a short sale. The fourth strategy involves no derivatives, but just a purchase prior to the records date and a sale subsequent to the record date to obtain the vote but to minimize the exposure to the risk in the change in the value of X stock.

¹²⁹ Sean Martin & Frank Partnoy and Bernie Black & Henry Hu analyze empty voting in some recent working papers, CITE. Our treatment differs from theirs in the following respects: INSERT.

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At present, the legal rules, and more generally the ability of companies to protect themselves, depends on the strategy used. Because equity swaps and zero-cost collars simply utilize third party, arm's length contracts, they are not currently subject to any special regulation. Moreover, these derivatives perform valuable functions outside the empty voting context. The last scheme is currently subject, at least in Delaware, to a judicially-created presumption that the post-record date purchaser is entitled to proxy from the seller/record owner entitling the purchaser to vote the shares.¹³⁰ The rule, however, does not significantly inhibit the use of the scheme because purchasers often do not ask for the proxy (thus permitting the seller to vote) and because the presumption could, in any case, be modified by agreement among the parties.¹³¹

The third strategy which relies on short selling is more complicated legally and institutionally and subject to more regulation, but achieves the same results. While there are various limitations on short-selling, these regulations do not currently interfere with the use of short-selling in this strategy.¹³²

Importantly, the Delaware law on "vote buying" probably does not apply to any of these strategies because they are not, by Delaware standards, vote buying at all. Although the Delaware law on vote buying has evolved over the years from a per se prohibition to a case by case analysis, every Delaware "vote buying" case involves the agreement of a shareholder or bondholder to vote his shares in a particular way in exchange for some payment. By contrast, none of the strategies outlined above have that sort of transaction present. While it is true that in each case HF ended up with votes, it does so by buying shares (with economic interests and votes) and then selling or hedging the economic interests. Buying votes by buying shares, even if the shares are then sold or hedged, has never been considered impermissible vote buying in Delaware.

Similarly, Delaware law applicable to short-selling also does not currently limit any of the strategies identified above. Although there are not many Delaware cases on the subject, the general view is that an investor's ownership position is, for various purposes, to be considered separate and apart from any offsetting short position. Thus, in *In re Digex*,¹³³ Elliot Associates, a hedge fund, challenged the interpretation of a settlement. Under the terms of the settlement, a \$165 million settlement fund was to be distributed to "all record and beneficial owners of Digex Class A common stock" during the class period. Elliot Associates argued that the settlement fund was improperly distributed because it did not take into account the creation of additional beneficial owners through their short selling activities. While Chancellor Chandler correctly acknowledged that short selling creates additional beneficial owners (although no additional record owners), he denied Elliot's motion on the grounds that their claim was against the record holders (their brokers) who were not parties to the case. In addition,

¹³⁰ CITE

¹³¹ This, however, may depress the price of the shares and thus impose greater costs on the seller.

¹³² See, e.g., Reg. SHO and accompanying release, Release No. 34-50103 (July 28, 2004).

¹³³ 2002 WL 749184 (Del. Ch.).

Chandler made the point that just as the standard short sale agreement requires that the short seller must indemnify the lender of borrowed shares for any cash dividends, so too they would have to indemnify the lender for any settlement amounts paid.

More recently, in *Deephaven Risk Arb Trading v. UnitedGlobalCom*,¹³⁴ Vice-Chancellor Parsons addressed the question whether a net short shareholder could compel inspection of books and records under Del. GCL §220. Deephaven, a hedge fund, held shares of UGC in various accounts, and also had short positions in the stock during the relevant time period. Although Deephaven's overall position was net short, at least one of its accounts held a long position throughout. Parsons rejected the UGC argument that, as a net short holder, Deephaven could not take advantage of §220. First, reviewing the history of §220 which originally was restricted to record holders, Parsons pointed out that §220 has never required a shareholder to have a direct economic interest in the stock (record holders often have no economic interest). When §220 was extended to beneficial owners, Parsons argued, the legislature simply extended the record holders' rights, and thus amended §220 cannot be read to impose any requirement of direct economic interest on beneficial owners. Second, Parsons held that, from a practical perspective, a requirement of a net long position was inappropriate. As Parsons pointed out, such a requirement would make what is intended to be a summary proceeding excessively complex as the court would have to "undertake a complex analysis to determine the plaintiff's financial position net of stock, options and other derivatives." In addition, the requirement of disclosing "sophisticated and proprietary trading techniques could have a chilling effect on the use of §220 by a substantial segment of stockholders." Finally, such complexity is unnecessary because the §220 "proper purpose" limitation serves to protect the corporation from "plaintiffs with economic incentives that are not aligned with other stockholders."

These cases together suggest that a direct attack on empty voting under Delaware law is likely to fail. So long as the standard voting structure is present, according to which record holders get to vote, the Delaware courts are unlikely to accept an invitation to cancel the votes of shareholders with off setting short positions even if such shareholders economic interests diverge from those of the other shareholders.

ii. Proposed Reforms

So what, if anything, should be done about empty voting? The easy part of the question is whether empty voting is in principle desirable. Shareholder voting plays an important, if limited, role in corporate governance. Certain significant transaction must be approved by shareholders; directors are elected by shareholders; various sorts of proposals – some binding, some not – are put to shareholder vote. Empty voting is inconsistent with the economic justifications for shareholder voting because, in these examples, the votes are being cast by people with an economic interest in the outcome

¹³⁴ 2005 WL 1713067 (Del. Ch.).

that is different from that of the shareholders generally. Thus, in principle, empty voting should not be permitted.¹³⁵

The harder part of the question is whether empty voting occurs at a scale that warrants intervention and, if it does, what form that intervention should take. The law has long recognized the fact that record date owners can vote their shares even if they have sold the shares before the vote. The law has tolerated it, presumably, because the administrative advantages of record dates outweigh the problem generated by the resulting empty votes. Now that hedge funds have, at least on occasion, tried to generate empty votes systematically in order to influence the outcome of a vote, the costs of permitting empty voting has increased. We lack the data to determine whether the costs have increased sufficiently to warrant a response (especially since, as we will see, there is no low cost way to eliminate the problem of empty voting). But, assuming that the problem is at least potentially of significant magnitude, what is the appropriate response? As the earlier discussions shows, one cannot attack any single strategy because of the easy availability of substitutes. In addition, tightening regulation on the component parts of the different strategies is likewise problematic because of the other valid purposes those component parts serve. A solution, if there is one, would have to be narrowly tailored to address the specific problem. There are several approaches that can be considered.

1. The Bankruptcy Model

Bankruptcy law provides an example of one approach. Section 1126(e) permits the disqualification of votes “not cast in good faith” in connection with the approval of a plan of reorganization: “On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title.”¹³⁶ Would it make sense for Delaware, either through legislation or caselaw, to disqualify votes as “not cast in good faith”?¹³⁷ The bankruptcy case law does not provide much comfort in anything but the most extreme cases.¹³⁸

[To insert: (a) brief discussion of the bankruptcy cases and what is wrong with the liberal use of “good faith” in bankruptcy; and (b) point out that the uncertainty generated by such a rule is less of a problem in bankruptcy than it would be in

¹³⁵ [Martin & Partnoy](#). But see Christoffersen, Gezcy, Musto and Reed, Vote Trading and Information Aggregation, working paper 2005 for an argument in favor of allowing vote trading.

¹³⁶ 11 U.S.C. §1126(e). For a full discussion, see Chaim Fortgang and Thomas Moers Mayer, Trading Claims and Taking Control of Corporations in Chapter 11, 12 Cardozo L. Rev. 1, 93-99 (1991).

¹³⁷ [Hints of such an approach could be found in Del. §144\(a\)\(2\) which relates to self interested transactions “approved in good faith by vote of the shareholders.” Delaware has mostly interpreted this “good faith” provision to mean no more than that the vote, to shift the burden of proof or standard of review, should be by disinterested shareholders. CITE?](#)

¹³⁸ *Id.*

corporate law because the issue can be dealt with in advance and because there is no mandated time for a vote..

In addition to the faults in an open-ended good faith voting rule, a “good faith” approach to voting does not directly meet the concerns of empty voting: empty votes can easily be cast in good faith. Moreover, non-empty votes can be cast in bad faith. As a result, a “good faith” voting rule would have ramifications well beyond the empty voting context. Delaware cases have stubbornly stuck to the position that shareholders can vote selfishly or strategically, e.g. by a controlling shareholder voting against an acquisition for self-interested reasons. A “good faith” voting rule would threaten this jurisprudence.¹³⁹

2. Imposing fiduciary duties on shareholders?

A second approach is suggested by Roberta Karmel’s suggestion that the time has come to impose a duty to the corporation on institutional shareholders.¹⁴⁰ Karmel is vague on the specifics of such a duty, and recognizes the tensions and potential conflicts between institutional investors’ duties to their beneficiaries and some unspecified duty to the corporation. But, one might ask, would the minimum content of such a duty include a duty not to vote shares in which one has no economic interest?

In essence, the suggestion is to control empty voting through an ex post, standards based strategy in which, through the mechanism of a “fiduciary duty”, judges would be expected to specify the content of the duty.¹⁴¹ Such an approach presents several difficulties. First, it runs counter to the major thrust of Delaware fiduciary duty law which has long held that shareholders can vote their shares as they wish. Second, it expands the duty of loyalty well beyond its core legal content of regulating transactions between a shareholder and the firm. Third, as Karmel recognizes generally, it presents intermediaries with a potential conflict between their duties to the beneficiaries to maximize the value of the fund and duties to the corporation or other shareholders, without providing any guidance for how to resolve such conflicts. If the duty to the beneficiaries always takes precedence, then the duty to the corporation is emptied of any content.

Although Karmel’s suggestion of imposing a general fiduciary duty on shareholders is unwarranted, there are various ways in which the concerns presented by empty voting could and perhaps will be reflected within the existing structure of Delaware M & A jurisprudence. First, management could likely justify under the Unocal/Unitrin standard significant defensive measures against a bidder for control who has established a large voting stake with no economic risk. [DISCUSS FURTHER].

¹³⁹ [Cite to Zohar’s article on strategic voting.](#)

¹⁴⁰ Roberta Karmel, Should a Duty to the Corporation Be Imposed on Institutional Shareholders?, 60 Bus. Lawyer 1 (2004).

¹⁴¹ See Kraakman et al at chapter ____.

More speculatively, management might try to disqualify the empty votes of a conflicted shareholder such as Perry in the Mylan-King transaction (which arose, as it happens, under Pennsylvania, and not Delaware law). Based on current jurisprudence, this would be an uphill battle. After all, in *Deephaven Risk Arb Trading v. UnitedGlobalCom*,¹⁴² discussed earlier, management's attempts to block an "empty shareholder" from inspecting books and records pursuant to Del. GCL §220 was rejected.

3. Net Long Position Charter Provision

We now consider a third approach which has not yet been extensively discussed in the literature: limiting shareholders to voting their net long position by charter provision.¹⁴³ In effect, this approach entails depriving shareholders of the voting rights from their long position to the extent that they engage in transactions that create off-setting short positions, whether these transactions take the form of swaps, options, or short sales. This approach, together with a mandatory rule requiring a record-date holder who sold her shares to give the proxy to the purchaser (or else not to vote the shares in a contested vote), could fix the problem of empty votes.

Is such an approach feasible under current conditions and, if not, what changes would be necessary to make it feasible? Consider, first, the feasibility under current law. For firms to enforce such a rule, they would have to be able to identify investors' net long positions and limit their votes to that position. An immediate problem is the availability of information: at present, there is no general requirement that investors disclose their short position.¹⁴⁴

But, while this interferes with the perfect implementation of the approach, it need not undermine it entirely. When an empty voting scheme involves more than 5% of the

¹⁴² 2005 WL 1713067 (Del. Ch.).

¹⁴³ Martin & Partnoy suggest, without working out the details, a version of the "net long position" rule. Working paper at 19. They are vague, however, on their proposal and its implementation. Black and Hu propose expanding the disclosure of derivative positions, a position with which we generally agree, but they do not address a net long position limitation. A version of our approach was proposed by the House Committee on Operations in 1991. "Short-Selling Activity in the Stock Market: Market Effects and the Need for Regulation," Part I, Report of the Committee on Government Operations, U.S. House of Representatives, Dec. 6, 1991, at 33.

¹⁴⁴ The SEC circulated a concept release in 1991 but did not promulgate any rules in the area. SEC, Public Disclosure of Material Short Security Positions, Securities Exchange Act of 1934, Release No. 34-29278, 1991 SEC LEXIS 1083 (1991). In the release, the SEC raised the issue whether, in light of the specific authority granted for the disclosure of long positions in 34 Act sections 13(d), 13(f) and 13(g), it needed a similar specific grant of authority to impose analogous reporting of short positions. *Id.* at *23. Later in the release, however, the SEC suggested that it had adequate authority under its "broad authority to adopt rules that define, or provide a means reasonably designed to prevent, fraudulent, manipulative or deceptive conduct." *Id.* at *24.

company' stock, the disclosure requirements under section 13(d) are triggered. They require the holder to "describe any contracts, arrangements, understandings or relationships (legal or otherwise) ... with respect to any securities of the issuer, including but not limited to, transfer or voting of any of the securities, finder's fees, joint ventures, loan or option arrangements, puts or calls, guarantees of profits, division of profits or loss, or the giving or withholding of proxies, naming the persons with whom such contracts, arrangements, understandings or relationships have been entered into."¹⁴⁵ This provision would seem to encompass the first three empty voting schemes and, indeed, Perry disclosed its hedging activities with regard to its Mylan shares pursuant to it.¹⁴⁶

Second, firms must be able to determine if a shareholder voted only net long interest or rather than its gross long position. The currently proxy system is not well structured to facilitate this check but could be easily modified without any regulatory reform. Under the current system, for shares held in street name, DTC executes an omnibus proxy granting DTC members (e.g., Merrill Lynch) a proxy to vote the shares that DTC holds for Merrill Lynch (and its customers). Merrill then provides a list of customer holdings to a proxy service provider, typically ADP, who then takes care of the actual distribution of proxy materials, cards specifying the number of shares that can be voted, and the tabulation of the votes. Under the current system, the issuer only receives overall voting instructions from the tabulator, and, depending on whether the firm provides for confidential voting, may only receive a list of shareholders and how many shares they voted. So what would prevent a customer from voting its gross rather than net long position? Under the current arrangements, nothing. But ADP already provides a list of shareholders and how many shares they voted. This list, combined with 13D reports, is sufficient to allow the issuer to ensure that 13D shareholders are not over-voting, and would allow issuers to enforce the net long rule without requiring ADP to disclose how individual customers voted. If the issuer discovered that a shareholder voted more than its net long position, it could simply ask ADP to reduce that shareholder's votes to its net long position.

Third, how might such a rule be implemented? Under current rules, companies have broad powers to determine voting rights. Delaware corporate law provides that "Unless otherwise provided in the certificate of incorporation and subject to Section 213 of this title, each stockholder shall be entitled to 1 vote for each share of capital stock held by such a stockholder."¹⁴⁷ Consistent with this, the statute also provides that the certificate of incorporation may contain "any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders or any class

¹⁴⁵ Schedule 13D, item 6.

¹⁴⁶ See Nov 29, 2004 Schedule 13D re Mylan Laboratories, filed by Perry Corp; Mar 21, 2005 Schedule 13D, Amendment No. 1, filed by Perry Corp.; Apr. 4, 2005, Schedule 13D, Amendment No. 2, filed by Perry Corp. Amendment No. 2 makes clear that Perry hedged his investment in Mylan through a combination of security-based swap agreements and short sales.

¹⁴⁷ Del. GCL §212(a).

of the stockholders.”¹⁴⁸ These two sections clearly authorize charter based restrictions on shareholder voting, and such restrictions have been upheld. For example, “tenure” voting – where shareholders who have held for more than a certain period of time get more votes per share than newer shareholders – appears in some charters.¹⁴⁹ In *Providence & Worcester v. Baker*,¹⁵⁰ the charter provided that each holder of common stock had one vote per share for the first fifty shares and only one vote per 20 shares for all shares above 50. A charter amendment that limited shareholder votes to a shareholders’ net long position should, in fact, be an easier case as it does not create any of the incentive problems created by these other voting rules. Indeed, it is simply a restoration of the statutory default setting of one share-one vote in light of changed market circumstances.¹⁵¹ Finally, it is consistent with the case law.

Under current law, one difficulty is the availability of information about short positions, which, while adequate to catch major attempts such as Perry’s, is still rather crude. To increase firms’ and investors’ ability to identify empty voting, the 13(d) disclosure requirements could be extended to require disclosure at a lower threshold, say 2%, and could be confined to circumstances involving potential empty votes. Specifically, the expansion of 13(d) could be very narrow and still allow firms to enforce a “net long” rule adequately well: persons with a long position involving at least 2% would be required to disclose any offsetting short positions involving at least 2%, and maintain the position at times where there is a non-ordinary vote (such as a contested director election or a vote on a merger).¹⁵²

Although a “net long position” rule seems possible, we do not want to understate the difficulties in implementation.¹⁵³ First, what counts as an off-setting short position? A long-short strategy is the easiest case. But what about more sophisticated strategies? Perry generated short positions that practically eliminated all of its economic interest in

¹⁴⁸ Del. GCL §102(b)(1).

¹⁴⁹ See, e.g., *Williams v. Geier*, 671 A.2d 1368 (Del. 1996) (charter amendment that gave current shareholders 10 votes per share; upon sale or transfer, shares revert to one vote per share, until the shares have been held for three years at which point they go back to ten votes share).

¹⁵⁰ 378 A.2d 121 (Del. 1977).

¹⁵¹ A charter amendment requires a board recommendation and approval of a majority of the shares. Del. GCL §242. But an amendment to limit shareholders to voting their net long position seems unlikely to be controversial. Boards, having seen Perry’s strategy in *Mylan-King*, would likely support it, and institutional shareholders should be in favor as well. The only opposition is likely to come from hedge funds who wish to preserve their degrees of freedom, and from issuers who might think the administrative burdens too great.

¹⁵² For an indication of the detail with which the underlying disclosure issues have already been worked out, see SEC, Commission Guidance on the Application of Certain Provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and Rules thereunder to Trading in Security Futures Products, Release Nos. 33-8107, 34-46101; 17 CFR Parts 231 and 241, 2002 SEC LEXIS 1607 (June 21, 2002).

¹⁵³ [Martin & Partnoy at ____](#).

King shares. But what if Perry retained some risk? Derivatives could easily be designed such that Perry only retained the risk that King stock dropped by more than 5%, or by less than 7%, or that it changed in either direction by at least 3%, and so on. A parallel concern arises with respect to stock options which give holders a net long position greater than their ownership of shares. And single-stock futures make things even more complex. Moreover, once we go down this path, the question is raised (and discussed by Martin & Partnoy) whether a rule *limiting* shareholders to voting their net long position should also *permit* the voting of net long positions by shareholders or non-shareholders?

These are tricky “line-drawing” questions that introduce a degree of uncertainty and discretion. Firms which adopt a “net long” rule could well face litigation over their calculation of the shareholder’s net long position. Moreover, we know from other contexts, unclear rules can be misused by management -- to deprive shareholders who disagree with them of votes, to let shareholders who agree with them keep their votes, or to reduce the number of shares entitled to vote and thus the vote required to approve certain corporate transactions. Indeed, in the best-known case of attempted empty voting, Perry – the hedge fund who held the empty votes – was to vote in favor of a merger recommended by management. If no further problems had arisen to cause Mylan to cancel the transaction, we suspect that Mylan’s management would have been less than eager to argue that Perry was not entitled to vote his shares in support of the merger that they had negotiated. In addition, and perhaps more importantly, whatever rules firms adopt will introduce a degree of complexity that hedge funds will likely exploit and which may in turn generate a need to respond.

These concerns suggest to us that, in the context of empty voting, regulatory intervention should be limited to requiring additional disclosure to provide the companies and the market with information about the extent of empty voting schemes.¹⁵⁴ As noted, such rules can be incorporated into the Section 13(d), which already results in the disclosure of empty voting schemes involving holders of 5% of the company’s stock. Such disclosure would serve three functions. First, it would provide information to determine whether any further response is warranted. Second, it would provide information to market participants who could respond to particular empty voting schemes when they learn about them. Market participants, for example, in learning that Perry had acquired empty votes in Mylan, and that Perry has an economic interest in having Mylan overpay for King, could infer that Perry believed that Mylan had overpaid, thereby making it more likely that Mylan shareholders would oppose the merger. Such disclosures could also trigger offsetting empty voting by investors such as Icahn with opposing interests. Third, companies would obtain information that would allow them to decide whether to adopt a charter provision to combat empty voting, what sort of provision to adopt, and aid in the enforcement of any such provision.

Beyond such disclosure regulation, however, we believe that firms have the ability and incentives to choose how to respond to empty voting. Most importantly, we believe that companies are better equipped than regulators to determine whether the potential for empty voting justifies for them a departure from the ordinary simple voting

¹⁵⁴ Black & Hu at ____.

rules and to determine what constitutes an off-setting short position that is sufficient to deprive a holder of her voting rights from a long position and what form this departure should take. Since these are complex issues, some experimentation among companies in devising proper responses, with the ability of companies to learn from each other, is desirable. Most importantly, companies are better able, and will act more speedily, to correct defects in a rule as hedge funds exploit imperfections in earlier ones.

V. Conclusion

We are observing the evolutionary process in the market for corporate control in real time. Hedge funds emerged, in part, because regulatory restrictions and the related limitations on permissible compensation structures removed much of the incentive for regulated institutional investor activism. The emergence of, and the role played by, hedge funds proves that there is money to be made from being an active shareholder.

One of the most intriguing developments is the division of labor between the hedge funds and the more traditional institutional investors. Because hedge funds are typically highly undiversified, they show little interest in agitating for systemic changes such as anti-poison pill or staggered board campaigns. On the other hand, hedge funds engage in firm specific agitation to a degree unheard of among traditional institutional investors. But the traditional institutions are happy to tag along. As one institution said, in connection with the battle to stop Deutsche Borse's attempt to acquire the London Stock Exchange, "The hedge funds have done a marvelous job. No matter how we feel about companies, traditional managers simply cannot move as fast to achieve our aims. We were right behind (the hedge funds), but we couldn't have done it without them."¹⁵⁵

On the other hand, an ad hoc coalition between hedge funds and traditional institutional investors will be good only if they know what is good for firms and have the discipline not to interfere inappropriately, and only if hedge funds are only supported in their "bright side" activities. Institutions may find themselves on the wrong side of a hedge fund maneuver, or follow hedge funds down a blind alley.

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

Finally, one can predict a backlash, although the exact form it takes will depend on what scandal occasions the regulatory intervention. We are already beginning to see a

¹⁵⁵ Sunday Times (London), Marj 13, 2005, Louise Armitstead, Saved by the growing power of hedge funds.

regulatory reaction with the SEC rules requiring the regulation of (some) hedge fund advisers. When there is the inevitable crisis, there will be pressure to regulate further. At this point, the most important injunction, obvious in a period of calm but less so after an explosion, is to regulate cautiously and carefully. There are two sides to hedge fund activism and excessive regulation of the dark side will undermine the very real benefits.