Towards Better Corporate Governance: A Comparative Study of Shareholder Activism in the US and the UK

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Declaration

I hereby declare that this thesis is my own work, except where indicated by referencing. It has not been submitted, in whole or in part, in support of another degree or professional qualification.

Abstract

This thesis examines the efficiency of institutional shareholder activism in the US and the UK and puts forward legal reform to increase its efficiency. It argues that corporate constituencies participate in the company to mitigate others' opportunism as a result of incomplete contracting. Thus the company's objective should be total utility maximization and the efficiency of shareholder activism should be assessed by comparing its costs and benefits to the company. This thesis finds that in general the benefits of shareholder activism lie in its improvement to corporate governance. The costs include self-interested activism, myopic activism and negative externalities. But the efficiency of shareholder activism is also heavily influenced by firm-specific factors, such as competitiveness of the product market, innovativeness of the company's business, corporate life stage and organizational structure. This thesis finds that mainstream institutional shareholders have weak incentives to initiate activism. Hedge funds have strong incentives to initiate both beneficial and detrimental activism. Thus this thesis argues that the efficiency of shareholder activism can be increased by encouraging mainstream institutional investors to vote on shareholder activism taking into consideration firm-specific factors. It proposes that due to the social impact of pension funds and mutual funds, they should have a regulatory duty to vote on shareholder activism to promote long-term corporate value. This duty should be accompanied by a duty to disclose their voting policies and records as well as explanations for the votes. The duties should be enforced by market discipline by end investors which is facilitated by public authorities. Public enforcement should function as an enforcement mechanism of the last resort.

List of Abbreviations

AMEX American Stock Exchange
CalPERS California Public Employees' Pension System
CalSTRS California State Teachers' Retirement System
CDO Collateralized Debt Obligations
DB Deutsche Borse
FCA Financial Conduct Authority
FRC Financial Reporting Council
FSA Financial Services Authority
FTSE Financial Times Stock Exchange
GL Glass Lewis
ISS Institutional Shareholder Service
LIBOR London Interbank Offered Rate
LSE London Stock Exchange
MSCI Morgan Stanley Capital International
NOL Net Operating Loss Carry Forwards
NRSRO Nationally Recognized Statistical Rating Organizations
NYSE New York Stock Exchange
OTC Over the Counter
P&G Procter & Gamble
R&D Research & Development
REIT Real Estate Investment Trust
SEC Securities and Exchange Commission
SG&A Sales, General and Administrative
S&P Standard & Poor's
TCI The Children's Investment Fund
USA United Shareholders Association

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Shareholder Rights Directive II (EU) No 2017/828 [2017] OJ L132/1
Short Selling Regulation (EU) No 236/2012 [2012] OJ L86/1
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Transparency Directive 2004/109/EC [2004] OJ L390/38
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Introduction

I. Significance of the Topic

Shareholder activism refers to shareholders' attempt to change how the company is managed. The US and the UK have seen a considerable level of shareholder activism in recent years. Companies targeted by activist shareholders include household names such as General Electric,[1] Apple, Tesco and Barclays.[2] Sawyer *et al* observed 268 public activism campaigns in the US in 2018.[3] The scale of shareholder activism alone calls for research on its effect on target companies. More importantly, shareholder activism encompasses two of the main issues in corporate governance, namely, what is the optimal division of power between the board and shareholders and what should be the company's objective.

Company law in most countries gives the board power to manage the company's ordinary business. But national legal systems differ greatly on the level of power shareholders are given to intervene with the board's decisions.[4] What is the optimal division of power between the board and shareholders has been much debated but little agreed on. At one end of the spectrum is the shareholder control approach, which proposes that shareholders should be able to direct the board and to veto its decisions.[5] At the other end of the spectrum is the board control approach, which argues that shareholders should only be given power to ensure board accountability by electing directors.[6] In between is the shareholder power approach, which advocates

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[1] Geoff Colvin, The Investor that Tipped on GE and P&G, Fortune (November 26, 2018).

[2] See Chapter 5.

[3] Melissa Sawyer, Lauren S. Boehmke, and Nathaniel R. Ludewig, Review and Analysis of 2018 US Shareholder Activism, Harvard Law School Forum on Corporate Governance and Financial Regulation, Accessed on August 25, 2019 at <https://corpgov.law.harvard.edu/2019/04/05/review-and-analysis-of-2018-u-s-shareholder-activism/>.

[4] John Armour, Luca Enriques, Henry Hansmann and Reinier Kraakman, "The Basic Governance Structure: The Interests of Shareholders as a Class" in Reineir Kraakman et al (eds) *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP, 2017), 50.

[5] Jeffrey Gordon, "Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law" (1991) 60 Cincinnati Law Review 347, 353.

[6] Stephen Bainbridge, Shareholder Activism and Institutional Investors, UCLA School of Law, Law-Econ Research Paper No. 05-20, Accessed on August 23, 2019 at

for strong shareholders' voting rights, including rights to initiate decision-making and to approve decisions that are fundamental to the company's future.[7] Another main issue in corporate governance is the company's objective, or more specifically, whether the company should be managed to solely maximize the wealth of shareholders or whether benefits of other stakeholders should also be promoted. Shareholder primacy is the ultimate shareholder-oriented approach as it combines shareholder control and shareholder wealth maximization.[8] Meanwhile, director primacy promotes board control and shareholder wealth maximization.[9]

Shareholder activism refers to shareholders' attempt to change how the company is managed using their existing level of power and other methods, such as media campaigns. Shareholder activism does not always have promoting shareholder interests as its goal. For example, as Hermes's shareholder, the People for the Ethical Treatment of Animals engaged in activism in 2017 against Hermes's use of animal skins for the making of handbags.[10] In fact, non-governmental organizations have grown to use shareholder activism to promote social and environmental policies.[11] But as most issues of shareholder activism are not relevant to this type of activism, it is not included in this thesis. In many cases activist shareholders succeed because the board agrees to their demands. As these shareholders influence, rather than exercise control, their successful activism is different from shareholder control. Some shareholder activism, such as proxy fights, does not seek to change power structures within companies. But when shareholder activism has increasing shareholder power as its objective and is successful, it achieves the result proposed by the shareholder power approach. In this light, rather than depending on policymakers or courts,

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<https://papers.ssrn.com/sol3/papers.cfm?abstract_id=796227>, 8.

[7] Lucian Bebchuk, "The Case for Increase Shareholder Power" (2005) 118 Harvard Law Review 833, 878.

[8] Stephen Bainbridge, "Director Primacy: The Means and Ends of Corporate Governance" (2002) 97 Northwestern University Law Review 547, 568.

[9] Ibid, 578.

[10] PETA, PETA's Push for Exotic-Skin Ban Heads to Hermes Boardroom, Accessed on April 29, 2019 at < https://www.peta.org/blog/petas-push-exotic-skin-ban-heads-hermes-boardroom/>.

[11] Terrence Guay, Jonathan Doh and Graham Sinclair, "Non-Governmental Organizations, Shareholder Activism, and Socially Responsible Investments: Ethical, Strategic, and Governance Implications" (2004) 52 Journal of Business Ethics 125, 125.

activism serves as shareholders' self-help measure to gain more power. Activist shareholders have already achieved some success in this aspect.[12] As the main manifestation of the exercise of shareholder power in real life, shareholder activism produces evidence that can be used to test the arguments proposed by theoretical and conceptual studies on the division of corporate power and corporate objective. A correct understanding of shareholder activism can also shed light on these wider issues.

II. Scope and Methodology of the Thesis

This thesis studies the economic effect of shareholder activism on target companies and designs legal reform to increase the efficiency of shareholder activism. A considerable number of studies have already been conducted on the economic effect of shareholder activism, but reached significantly different conclusions. One reason for this is that the studies were based on different normative positions on the optimal level of shareholder power and corporate objective. Researchers who endorse board control tend to view shareholder activism negatively while advocates for shareholder wealth maximization disregard the effect of shareholder activism on other stakeholders.[13] Thus these issues must be settled before the examination of shareholder activism. This thesis argues that shareholders and other stakeholders participate in the company by giving control over their capital to the company to mitigate others' opportunism. The company, through the board, should exercise control to minimize corporate constituencies' opportunistic behavior. But directors have agency problems, making complete board control undesirable. Hence shareholders should be given a level of power which allows them to ensure board accountability. Meanwhile, as all corporate constituencies participate in the company to mitigate others' opportunism, shareholder should not be able to transfer value from other stakeholders to themselves. The company's objective should be the

[12] See Chapter 2 on the destaggering of boards in Delaware.
[13] Bainsbridge, supra note 6, 8.

maximization of corporate constituencies' total utility, in the form of shareholder wealth maximization in the long term. Therefore, the optimal level of shareholder power should allow shareholders to maximize the reduction of agency costs at minimal costs to other stakeholders. The economic effect of shareholder activism should be assessed by comparing its costs and benefits to the company in the long term.

But this thesis does not conduct original quantitative research on the economic effects of shareholder activism. A large number of studies have already been conducted to this effect. Most of these studies distinguished between different types of activist shareholders, activism with different objectives and strategies. But they neglected to explore how the same type of activism campaign can have different effects on companies with different characteristics, which is the second reason for the inconclusiveness of existing literature. To fill this gap, research priority should be the identification of such firm-specific factors, which can form the basis for designing more granular quantitative studies in the future.

This thesis conducts case studies to identify firm-specific factors which might influence the economic effects of shareholder activism. Case studies examine subjects in contexts and are particularly suitable to study phenomena such as shareholder activism which occur in an array of complex situations. Analyzing these factors are also inductive to the formation of hypotheses. The main limitation of case studies is that findings in specific contexts might not be generalizable. This calls for future empirical studies to test the hypotheses formed in case studies. But case studies are essential to research on shareholder activism even when their findings are only context-specific. Shareholder activism is a real life phenomenon. Many important factors, such as the level of tension between activist shareholders and target companies, cannot be captured by either theoretical or quantitative studies.[14] The

[14] Martin Lipton, Empiricism and Experience; Activism and Short-Termism; the Real World of Business, Harvard Law School Forum on Corporate Governance and Financial Regulation, Accessed on September 4, 2019 at <https://corpgov.law.harvard.edu/2013/10/28/empiricism-and-experience-activism-and-short-termism-the-real-world-of-business/>.

addition of evidence arising from case studies produces a fuller picture of shareholder activism.

This thesis focuses mainly on listed companies in the US and the UK. It does not cover private companies because they cannot issue shares to the public. Hence the managerial agency problem is minimal in private companies. As the capital market plays an important corporate governance role in the US and the UK, this thesis focuses on listed companies. The scope of this thesis is limited to the US and the UK because share ownership in other countries is concentrated. Large shareholders are generally insiders from a corporate governance perspective. Their intervention with the board's decisions is more akin to internal corporate decision-making, not shareholder activism. Meanwhile, the presence of large shareholders strongly discourages small shareholders from activism. Thus shareholder activism is rare in these countries. Share ownership in the US and the UK is dispersed. This makes most shareholders outsiders and the Anglo-American corporate governance system a market-based system. As shareholder activism is essentially shareholders' attempt to influence corporate management from the outside, it is a somewhat unique phenomenon in the US and the UK. Moreover, the two countries give shareholders different levels of power. Comparing shareholder activism in the US and the UK shows how the level of shareholder power affects their behavior and sheds light on the wider issue of what is the optimal level of shareholder power.

But this does not limit the application of this thesis to the US and the UK. There has been some fragmentation of share ownership in other countries. For example, the rise of other capital providers in Germany has prompted banks, which used to be significant shareholders, to reduce their shareholdings and board seats.[15] Less concentrated share ownership makes shareholder activism easier. Activist shareholders with growing assets in the US and the UK are also expanding activism

[15] Sudi Sudarasanam and Tim Broadhurst, "Corporate Governance Convergence through Shareholder Activism: Impact of the Deutsche Borse Bid for London Stock Exchange" (2012) 16 Journal of Management and Governance 235, 247.

activities to other countries. Samsung,[16] Sony[17] and Deutsche Borse[18] have all been targets of shareholder activism. Activism by shareholders based in the US and the UK could encourage domestic shareholders to be more active. Thus there is likely to be an increasing level of shareholder activism in other countries. As the issues are likely to be the same, a correct understanding of shareholder activism in the US and the UK can guide the development of shareholder activism in other countries.

III. Overview of the Chapters

This thesis is organized as follows. Chapter 1 introduces the *status quo* of shareholder activism. The current landscape of shareholder activism is dominated by hedge funds which initiate activism campaigns. Mainstream institutional investors also play important roles by voting on shareholder activism. This chapter explores reasons behind this phenomenon by studying the history of shareholder activism. It starts from dispersed share ownership and the consequent collective action problem and free-rider problem. It then examines the growth of institutional share ownership and mainstream institutional shareholders' economic disincentives against activism, including their concerns of liquidity and externalities, conflicts of interest and the agency problem of fund managers. Finally, this chapter looks at the emergence of activist hedge funds and finds that most of the disincentives do not exist for hedge funds.

Chapter 2 introduces how shareholders can engage in activism in the US and the UK by comparing the division of power between the board and shareholders in the two countries. It examines limits to directors' power, namely directors' duties, including whether they can frustrate takeovers, and shareholders' power to bring derivative claims, to remove directors, to submit shareholder proposals and to vote on major corporate actions.

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[16] Trefis Team, An Activist Investor Aims to Reshape Samsung, Forbes (October 7, 2016).

[17] Kana Inagaki, Sony Prepares for Second Campaign by Activist Investor Loeb, Financial Times (April 23, 2019).

[18] See Chapter 4.

Chapter 3 builds a theoretical framework of the company to answer two questions, namely what is the optimal division of power between the board and shareholders and what is the company's objective. In order to do so, it analyzes main theories on the subject, including the concession theory, the managerialist theory, the contractarian theory and its variants. It argues that the company's objective should be total utility maximization and that the optimal level of shareholder power should minimize agency costs with the least costs to the company. As shareholders' exercise of power, the economic effect of shareholder activism should be assessed by weighting its benefits and costs to the company in the long term. This chapter also examines the limits of shareholder activism's benefits, or to what extent the agency problem is effectively controlled by existing corporate governance mechanisms, namely board monitoring, incentive alignment and market discipline.

Chapter 4 examines the benefits and costs of shareholder activism to the company in the long term. The benefits of activism lie in the reduction of agency costs. The costs of activism encompass the risk of self-interested activism and short-termist activism as well as negative externalities on other stakeholders. This chapter also examines empirical studies on the economic effect of shareholder activism. It finds that the studies are inconclusive because they have neglected how features of target companies can affect the outcome of shareholder activism.

Chapter 5 fills this gap by conducting case studies to explore what firm-specific factors might affect the economic outcome of shareholder activism. It finds tentative support for the proposition that competitiveness of the product market, innovativeness of the company's business, corporate life stage and organizational structures influence the economic effect of shareholder activism.

The question that logically follows is whether initiators of shareholder activism have incentives to take these firm-specific factors into consideration and whether other shareholders would have regard to these factors in voting. Chapter 6 examines potential legal obstacles against such tailored shareholder activism. It reviews rules on portfolio diversification, mandatory disclosure of large shareholdings, shareholder cooperation, insider trading and control person liability. It concludes that none of the

rules acts as major disincentive against shareholder activism.

Chapter 7 puts forward legal reform to increase the efficiency of shareholder activism, or in other words, to increase the benefits or to decrease the costs of activism. It argues that since hedge funds have strong incentives to initiate both beneficial and detrimental shareholder activism which cannot succeed without the support of other shareholders, the efficiency of activism can be increased by encouraging other shareholders to vote responsibly on activism. It proposes that given the social impact of pension funds and mutual funds, they should be imposed a regulatory duty of informed voting on shareholder activism matters so as to promote long-term corporate value. This duty should be accompanied by a duty to publicly explain their voting and be enforced by end investors in the funds as well as by public authorities using the technique known as regulatory diamond.

Chapter 8 concludes.

Chapter 1 An Overview of Shareholder Activism

This chapter introduces the *status quo* of shareholder activism on which any legal reform will be based. The current landscape of shareholder activism is mostly dominated by hedge funds which initiate activism campaigns. Other institutional investors participate by voting on shareholder activism. This chapter explores reasons behind this phenomenon by studying the development of shareholder activism. It starts from the dispersion of share ownership, the consequent collective action problem and free-rider problem, which result in the traditional passivity of shareholders. It then examines the growth of mainstream institutional investors' shareholdings and their potential to engage in activism. This is followed by the marked passivity of mainstream institutional shareholders and an analysis of their economic disincentives against activism. This chapter then looks at the emergence of activist hedge funds and finds that most of the economic disincentives do not exist for hedge funds. Thus the current landscape of shareholder activism is dominated by hedge funds. The image of hedge funds as aggressive and frequent traders casts doubt on the economic effect of shareholder activism on target companies, which will be explored in subsequent chapters.

This chapter is organized as follows. Section I introduces the concept of dispersion of share ownership and its implications. Section II discusses the rise of mainstream institutional shareholders and their capacity to engage in activism. Section III explains the rarity of activism by mainstream institutional shareholders by examining four of their economic disincentives against activism, namely concerns over liquidity and externalities, conflicts of interest and agency problems of fund managers. Section IV studies hedge funds and their incentives to engage in shareholder activism. Section V concludes.

I. Dispersed Share Ownership

In 1932, Berle and Means observed that share ownership in public companies in

the US was dispersed.[1] After studying share ownership in the 200 largest public companies in the US, they found that corporate shares were no longer concentrated in the hands of a few wealthy investors. Instead, share ownership was diffused among the investing public, with the largest shareholders holding less than one percent of the companies' shares. The fragmentation of share ownership was also picked up by public companies of smaller size.[2] With regard to the UK, although it is unclear when share ownership started to diffuse, the general consensus is that the dispersion was completed in the 1980s.[3] Currently the US and the UK are the only two nations with widespread dispersed share ownership.[4] This raises two questions: why is share ownership dispersed only in the US and the UK and what are its implications?

1. Causes

The traditional explanation for dispersed share ownership is that technological advancement and the consequent industrial development fueled an unprecedented level of corporate growth, which required large amounts of capital. Since industrial development also created jobs and a larger, wealthier middle class, companies turned to the public for capital which in turn fragmented their share ownership.[5] The problem with this line of reasoning is that it cannot explain why share ownership remained concentrated in other developed nations, such as Germany.

Meanwhile, La Porta *et al* argued that since minority shareholders are vulnerable to the exploitation of majority shareholders and the management, investors would only be willing to take minority positions in companies when there is strong minority

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[1] Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property*, (10th edn, Transaction Publishers, 2009) 53.
[2] Ibid, 59.
[3] John Coffee, Dispersed Ownership: The Theories, the Evidence and the Ending Tension between Lumpers and Splitters, ECGI Law Working Paper 144/2010, Accessed on August 12, 2019 at <https://ecgi.global/sites/default/files/working_papers/documents/SSRN-id1532922.pdf>.
[4] For example, La Porta *et al* studied share ownership in 27 countries in 1995. Defining widely held companies as companies without shareholders having more than 10% of voting rights, they found that only the US and the UK had large percentages of widely held companies.
See Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, "Corporate Ownership around the World" (1999) 54 Journal of Finance 471, 494.
[5] Coffee, supra note 3, at 12.

protection.[6] For example, La Porta *et al* found that a two-standard-deviation-increase in their anti-self-dealing index led to a six-percentage-point-decrease in share ownership concentration.[7] Hence dispersed share ownership is most prevalent in the US and the UK because the two nations have the strongest minority protection rules.[8] The problem with this argument is reversed causality, that strong minority protection rules might be the law's response to dispersed share ownership, not the cause.[9] Indeed in both the US and the UK, many minority protection rules were adopted after the dispersion of share ownership was completed. For instance, in the US, insider trading was addressed by the SEC's Rule 10b-5 under the Securities Exchange Act of 1934.[10] The rule is a general anti-fraud rule. Case law applying the rule to insider trading was developed much later.[11] In the UK insider trading was first regulated in the Companies Act 1980.[12]

Interestingly, many minority protection rules were first implemented by stock exchanges. For example, the New York Stock Exchange required listed companies to publicly disclose their financial statements every quarter of the year in as early as the 1920s.[13] Statutory rules on the same matter were implemented a decade later.[14] In contrast, the London Stock Exchange started to demand corporate disclosure on an ongoing basis in the 1950s, although it still predated the introduction of statutory rules on this subject.[15] Coffee argued that the NYSE was quicker to introduce minority protection rules than the LSE because it faced more intense competition. In order to

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[6] Rafael La Porta, Florencio Lopez de Silanes and Andrei Shleifer, "What Works in Securities Laws?" (2006) 61 Journal of Finance 1, 13.
[7] Rafael La Porta, Florencio Lopez de Silanes and Andrei Shleifer, "The Economic Consequences of Legal Origins" (2008) 46 Journal of Economic Literature 285, 294.
[8] Ibid.
[9] Howell Jackson and Mark Roe, "Public and Private Enforcement of Securities Laws: Resource-Based Evidence" (2009) 93 Journal of Financial Economics 207, 233.
[10] The Securities Exchange Act of 1934 was codified at 15 U.S.C. § 78a through § 78 qq.
SEC Rules and Regulations under the Securities Exchange Act of 1934 was codified at 17 C.F.R Part 240.
17 C.F.R § 240.10b-5.
[11] See Chapter 6.
[12] Companies Act 1980, Section 68-73.
[13] Paul Mahoney, "The Exchange as Regulator" (1997) 83 Virginia Law Review 1453, 1466.
[14] Quarterly reports must be filed with the SEC on Form 10Q.
17 C.F.R § 240.13a-13.
[15] Brian Cheffins, "Does Law Matter? The Separation of Ownership and Control in the United Kingdom" (2001) 30 The Journal of Legal Studies 459, 475-479.

stand out from other national and state stock exchanges, the NYSE sought to ensure a high level of investor protection. Meanwhile, the LSE had little competition and for some time was more interested in attracting new listings than acting as investors' guardians.[16] Nevertheless, stock exchanges charge fees for each transaction and have incentives to encourage small investors to participate in the market. The NYSE and the LSE were self-regulatory organizations at the time and were free to act on the incentives by introducing minority protection rules.[17] The rules led to the dispersion of share ownership which prompted the law to respond by putting the rules on a statutory footing and by further enhancing minority protection.

Meanwhile, political economies in other nations were more centralized. Their stock exchanges were closely affiliated with their governments and were less free to introduce minority protection rules.[18] As a result, investors either had large shareholdings or refrained from investing. The low participation of small investors reduced the stock market's capital raising capacity, making companies less reliant on the stock market for capital. For example, after adjusting for the size of population, Franks and Mayer found that countries with concentrated share ownership had fewer listed companies than the US and the UK.[19] Companies in these countries relied more on investors in the private market for capital, such as banks which were also their creditors and other companies with which they had other business ties.[20] These non-equity relationships and the size of their stakes[21] made it difficult for large shareholders to sell their shares. But they also gave large shareholders access to non-public information, which allowed them to monitor and discipline corporate management. Hence large shareholders were insiders from a corporate governance perspective and corporate governance systems in countries with concentrated share

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[16] Coffee, supra note 3, at 39.
[17] Ibid, 38.
[18] Ibid.
[19] Julian Franks and Colin Mayer, Evolution of Ownership and Control Around the World: The Changing Face of Capitalism, ECGI Finance Working Paper No. 503/2017, Accessed on August 15, 2019 at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2954589>, at 4.
[20] Julian Franks and Colin Mayer, "Corporate Ownership and Control in the UK, Germany and France" (1997) 94 Journal of Applied Corporate Finance 30, 31.
[21] See Section III.

ownership could be characterized as insider systems.[22] The establishment of insider systems persists the concentration of share ownership even after minority protection rules were introduced.

2. Implications

Hirschman proposed that members who are dissatisfied with their organizations have three options, exit, voice and loyalty.[23] The use of the voice option refers to members' expression of dissatisfaction, such as going on protests or casting negative votes. In many cases, it involves attempt of members to make their organizations take actions which are favoured by them. Shareholder activism is shareholders' exercise of the voice option.

Shareholders' benefits from activism are mostly proportionate to their shareholdings. Hence the benefits would be insignificant for small shareholders. Meanwhile, the costs are substantial. To engage in activism, shareholders need to monitor the company, identify its problems and find solutions to the problems, all of which are costly to small shareholders who do not have access to much corporate information.

Moreover, as will be discussed in Chapter 2, most shareholder actions require a considerable percentage of votes to be initiated and to succeed. In companies with dispersed share ownership, successful shareholder actions could require coalition of thousands of shareholders.[24] Forming such coalitions would be costly. Taking shareholder actions is also likely to be expensive. For example, Gantchev estimated that negotiation with the board alone took $2.94 million.[25] For initiators of shareholder activism as well as other shareholders, if shareholders could agree to share the costs, their benefits from activism would be more likely to outweigh the

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[22] Franks and Mayer, supra note 19, 31.

[23] Albert Hirschman, "Exit, Voice and Loyalty: Further Reflections and a Survey of Recent Contributions" (1980) 58 The Milbank Memorial Quarterly 430, 430.

[24] Andrew Keay, "Company Directors Behaving Poorly: Disciplinary Options for Shareholders" (2007) Journal of Business Law 656, 660.

[25] Nickolay Gantchev, "The Costs of Shareholder Activism: Evidence from a Sequential Decision Model" (2013) 107 Journal of Financial Economics 610, 612.

costs. But cooperation is difficult, if not impossible, to be achieved with such large numbers of players, a problem known as the collective action problem.[26] Suppose the management's submission of a proposal has depressed the company's share price. A majority vote against the proposal could restore the share price to its previous level. But the price would drop further with more shareholders selling their shares. The decline in share price would be irreversible if the proposal is passed. This is a case of prisoners' dilemma.[27] It is in shareholders' collective interests to cooperate. But in case of other shareholders' defection, cooperative shareholders would be made worse off. Players in a classic prisoners' dilemma are not allowed to communicate with each other. In this case, although shareholders are free to communicate, it is impossible to make enough small shareholders promise credibly not to defect. Hence instead of cooperation, shareholders would choose the second-best option by selling their shares at the current price.

Shareholders also have incentives to free-ride.[28] Increased corporate value is a public good for shareholders. Contrary to private goods which can only be used by their owners, producers of public goods are unable to exclude others from using or profiting from the goods.[29] This is the case for shareholders. If shareholder activism increases the company's value, all shareholders will benefit, regardless of whether they have participated in the actions. Shareholders' ability to free-ride reduces their incentives to share the costs of activism.

The collective action problem and the free-rider problem mean that small shareholders who initiate activism would bear the full costs of activism. Since the costs are mostly likely to outweigh the benefits, no small shareholder has incentive to engage in activism. Exit, or selling their shares, is a more attractive option for small shareholders. Exit is costly for large shareholders. Unloading large quantities of

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[26] Lynn Stout, "The Mythical Benefits of Shareholder Control" (2007) 93 Virginia Law Review 789, 807.

[27] Bo Gong, *Understanding Institutional Shareholder Activism: A Comparative Study of the UK and China* (Routledge 2014) 32.

[28] Anat Admati, Paul Pfleiderer and Josef Zechner, "Large Shareholder Activism, Risk Sharing and Financial Market Equilibrium" (1994) 102 Journal of Political Economy 1097, 1100.

[29] John Coffee, "Market Failure and the Economic Case for a Mandatory Disclosure System" (1984) 70 Virginia Law Review 717, 725.

shares onto the market would result in more supply than demand, depressing the price. Moreover, investors generally believe that large shareholders exit based on negative insider information. This would make them bid down the share price even further.[30] Neither problem exists for small shareholders. Exit is especially easy in the US and the UK where the markets are more liquid, with more companies available for investment and more investors willing to take over the shares.[31] As shareholders in the US and the UK generally prefer exit over voice, the Anglo-American corporate governance system is often characterized as an outsider system[32] or a market-based system.[33] The passivity of small shareholders also resulted in corporate control being exercised by managers, a phenomenon termed by Berle and Means as the separation of ownership and control.[34]

II. Mainstream Institutional Shareholders

1. The Growth of Institutional Shareholder Ownership

Shareholder activism became a real possibility in the US and the UK with the growth of institutional share ownership. In the US, institutional investors owned 80% of the S&P 500 index and 78% of the Russell 3000 index in 2017.[35] In 2016, 31.5% of shares quoted in the UK were owned by domestic institutional investors and 53.9% were owned by foreign institutions.[36] This section introduces mainstream institutional investors, namely pension funds, life insurers and mutual funds. Hedge funds will be

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[30] John Coffee, "Liquidity Versus Control: The Institutional Investor as Corporate Monitor" (1991) 91 Columbia Law Review 1277, 1320.
[31] Edith Ginglinger and Jacques Hamon, Ownership, Control and Market Liquidity, Finance International Meeting AFFI-EUROFIDAI Paper, Accessed on August 15, 2019 at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1071624>, at 14.
[32] Franks and Mayer, supra note 20, at 31.
[33] Toru Yoshikawa and Abdul Rasheed, "Convergence of Corporate Governance: Critical Review and Future Directions" (2009) 17 Corporate Governance: An International Review 388, 401.
[34] Berle and Means, supra note 1, 66.
[35] Charles McGrath, 80% of Equity Market Cap Held by Institutions, Pensions & Investments (April 25, 2017).
[36] Office for National Statistics, Ownership of UK Quoted Shares 2016, Accessed on April 29, 2019 at <https://www.ons.gov.uk/economy/investmentspensionsandtrusts/bulletins/ownershipofukquotedshares/2016>.

discussed in Section IV.[37]

Pension funds provide beneficiaries with retirement income. Both employees and their employers contribute to the funds, which invest in various markets in order to generate returns to pay for pension claims. Based on identities of sponsors, pension funds can be categorized into public and private pension funds.[38] Public pension funds are pension funds for employees in the public sector and the state as employer contributes to the funds. Private pension funds are also called corporate pension funds, which are funded by employers in the private sector. Pension funds can also be categorized into defined contribution funds and defined benefit funds. As suggested by name, beneficiaries of defined contribution funds contribute a certain amount of salaries into the funds. They bear the funds' investment risks as the size of their retirement income depends on the funds' investment returns. Meanwhile, defined benefit funds bear the investment risks themselves and provide their beneficiaries with a fixed amount of retirement income.[39] Employees' longer life expectancy has largely increased pension liabilities, making defined benefit funds unattractive to sponsors.[40] Defined benefit funds have also grown unpopular among employees as they restrict job mobility by requiring employees to work for several years to be qualified for the funds. Hence defined contribution funds have replaced defined

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[37] Sovereign wealth funds are state-owned investment funds. Some sovereign wealth funds, such as Norway's Norges Bank Investment Management and Qatar's Qatar Holding, have engaged in a level of shareholder activism. But their activism has wider socio-economic effects than the activism of other institutional investors. On the one hand, sovereign wealth funds might engage in shareholder activism to advance their states' political agendas. Their influence over companies in key industries, such as energy and transportation, create national security concerns. On the other hand, strict restrictions on the investments of sovereign wealth funds could discourage the inflow of foreign capital. As these wider socio-economic issues are beyond the scope of this thesis, shareholder activism by sovereign wealth funds is not examined in this thesis. See Adam Gutin, "Regulating Sovereign Wealth Funds in the US: A Primer on SWFs and CFIUS" (2010) 5 FIU Law Review 745; Joel Slawotsky, "Incipient Activism of Sovereign Wealth Funds and the Need to Update United States Securities Law" (2015) International Review of Law 1

[38] Roger Barker and Iris Chiu, *Corporate Governance and Investment Management: The Promises and Limitations of the New Financial Economy* (Edward Elgar, 2017) 199.

[39] Ibid.

[40] Alex Zhavoronkov, "Longevity Expectations in the Pension Fund, Insurance and Employee Benefits Industry" (2015) 8 Psychology Research and Behavior Management 27, 27.

benefit funds as the norm.[41]

Life insurers also provide for retirement income. Policyholders pay life insurers premiums, which are invested by the insurers to generate retirement income for policyholders.[42] Life insurers are different from other insurers as the event they insure, namely, retirement, is a certainty. For other insurers, insured events, such as car accidents, might not happen.[43] There are two types of life insurance policies, non-profit policies and with-profits policies. Retirement income provided by with-profits policies varies according to the insurers' investment performance while policyholders of non-profit policies receive a fixed amount of retirement income until death.[44]

Pension funds and life insurers in the US and the UK saw a significant growth in assets after the Second World War. This is because unlike countries which provided generous state pensions, the US and the UK encouraged workers to opt out of state pensions by arranging for private retirement savings.[45] In order to achieve this goal, both countries granted pension funds and insurance companies favourable tax treatments. For example, the UK exempted insurance companies from capital gains taxes in 1965, while the tax rates for individuals were 30%.[46] Originally pension funds and insurance companies preferred to invest in other classes of assets, such as mortgages and bonds, over shares. Downturns in these markets coincided with the growth of institutional assets and the boom of the equity market, which prompted a considerable growth in institutional share ownership.[47]

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[41] Paul Myners, Institutional Investment in the UK: A Review (March6, 2001) (hereafter The Myners Review) para 6.5.
[42] Ibid, para 9.1.
[43] Ewan McGaughey, "Does Corporate Governance Exclude the Ultimate Investor?" (2016) 16 Journal of Corporate Law Studies 221, 234.
[44] Graeme Douglas, Joseph Noss and Nicholas Vause, The Impact of Solvency II Regulation on Life Insurers' Investment Behavior, Bank of England Staff Working Paper No. 664, Accessed on August 16, 2019 at <https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2017/the-impact-of-solvency-2-regulations-on-life-insurers-investment-behaviour>, at 5.
[45] Richard Buxbaum, "Institutional Owners and Corporate Managers: A Comparative Perspective" (1991) 57 Brooklyn Law Review 1, 9.
[46] Janette Rutterford and Leslie Hannah, "The Rise of Institutional Investors" in David Chambers and Elroy Dimson (eds), *Financial Market History: Reflections on the Past for Investors Today* (CFA Institute Research Foundation, 2017), 242.
[47] Ibid.

The rise of mutual funds was a different story, which could be largely attributed to the dispersion of shareholder ownership. Mutual funds invest assets pooled from individual investors. Broadly, there are two types of mutual funds. Investors in open-ended funds can withdraw assets from the funds on short notice while investors in closed-ended funds are locked in the funds for a certain period of time. In the UK, unit trusts are open-ended and investment trusts are closed-ended.[48] With dispersed share ownership, the market was dominated by individual investors most of whom did not have business expertise and required professional advice.[49] At the same time, the diversification theory rose to prominence.[50] The theory proposed that firm-specific risk could be cancelled out by constructing a fully diversified portfolio.[51] But full diversification was not available to most individual investors who had limited wealth. Mutual funds offered a solution to these issues. Mutual funds are professionally managed. Pooling assets from individual investors allows them to have large assets and to be fully diversified.[52] Thus mutual funds became particularly popular in the US and the UK where markets are dominated by small investors.

Clark proposed that capitalism has four stages. At the first stage, corporate ownership and control is united in the hands of entrepreneurs.[53] One of its problems is that it excludes those who only have wealth or managerial skills.[54] The emergence of professional managers and capital providers responds to this problem, moving capitalism to the second stage, which is marked by the separation of ownership and control.[55] The current dominance of institutional investors represents the third stage, which is also characterized as intermediary capitalism[56] or fiduciary capitalism.[57]

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[48] Barker and Chiu, supra note 38, 260.
[49] Leora Klapper, Victor Sulla and Dimitri Vittas, "The Development of Mutual Funds around the World" (2004) 5 Emerging Markets Review 1, 6.
[50] See Chapter 6.
[51] Myles Mangram, "A Simplified Perspective of the Markowitz Portfolio Theory" (2013)7 Global Journal of Business Research 59, 60.
[52] Klapper et al, supra note 49, 6.
[53] Robert Clark, "The Four Stages of Capitalism: Reflections on Investment Management Treatises" (1981) 94 Harvard Law Review 561, 562.
[54] Eugene Fama and Michael Jensen, "Separation of Ownership and Control" (1983) 26 Journal of Law and Economics 301, 306.
[55] Clark, supra note 53, 563.
[56] Paul Edelman, "Shareholder Voting in an Age of Intermediary Capitalism" (2014) 87 Southern California Law Review 101, 101.

Clark predicated that eventually end investors in investment funds would go beyond their financial returns to make the funds pursue wider social objectives. This would be the fourth stage of capitalism, which is also termed as pension fund socialism.[58] As will be discussed in Chapter 7, this is not yet the case and one of this thesis's objectives is to promote this stage of capitalism.

2. Institutional Shareholder Activism

Cost-benefit analysis of shareholder activism is altered for institutional shareholders. Institutional shareholders have much larger positions and more potential benefits from activism. Their relatively large positions also mean that successful shareholder actions can be achieved with the cooperation of a few institutional shareholders, reducing the costs of activism. As institutional investors are widely diversified, they often invest in the same companies. As repeat players, the prisoners' dilemma problem is mitigated.[59] Using the example in the previous section, if shareholders all have stakes in another company, cooperative shareholders can punish defective shareholders by not cooperating with them in the other company. This would reduce shareholders' incentives to defect. Institutional investors which invest in the same companies can even develop procedures on cooperation to further reduce the costs of activism. Due to their relatively large positions, institutional shareholders are more likely to consider themselves pivotal players, that their actions would change the company's course of action.[60] This reduces their incentives to free-ride.

Share ownership by domestic institutional investors reached its height in both the US and the UK in the 1990s. This continues to be the case in the US. But institutional

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[57] James Hawley and Andrew Williams, "The Emergence of Fiduciary Capitalism" (1997) 5 Corporate Governance: An International Review 206, 206.

[58] Gordon Clark and Tessa Hebb, "Pension Fund Corporate Engagement: The Fifth Stage of Capitalism" (2004) 59 Industrial Relations 142, 143.

[59] Dirk Zetzsche, Challenging Wolf Packs: Thoughts on Efficient Enforcement of Shareholder Transparency Rules, Center for Business and Corporate Law Research Paper Series No. 0044/09, Accessed on August 16, 2019 at < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1428899>, at 40.

[60] Bengt Holmstrom and Barry Nalebuff, "To the Raider Goes the Surplus? A Reexamination of the Free-Rider Problem" (1992) 1 Journal of Economics and Management Strategy 37, 46.

investors in the UK have been switching to overseas markets and their share ownership in domestic companies has decreased since the 1990s. For example, Cheffins found that in 1993 domestic institutional investors owned 60% of shares quoted in the UK. The number dropped to below 33% in 2008.[61] Institutional investors' significant share ownership in the 1990s raised high hope in the academia for institutional shareholder activism. However, although there were some high-profile cases in the US, mostly carried out by public pension funds,[62] institutional shareholder activism never reached the expected level. It was even rarer in the UK.[63] Chapter 6 will discuss legal disincentives against institutional shareholder activism. The next section explores institutional shareholders' economic disincentives against activism.

III. Economic Disincentives against Institutional Shareholder Activism

1. Liquidity

In the US, open-ended funds must redeem end investors' securities in the funds within 7 days of receiving the requests.[64] In practice most redemption is completed on the same day.[65] Daily redemption is mandated in the UK.[66]

To be able to repurchase securities from a large number of end investors on short notice, open-ended funds might need to sell some of their assets. This possibility discourages them from investments whose returns could not be realized in the short

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[61] Brian Cheffins, "The Stewardship Code's Achilles' Heel" (2010) 73 Modern Law Review 1004, 1017.

[62] The California Public Employees Pension System (CalPERS) launched a series of activism campaigns. Their effect on corporate value was termed the CalPERS effect.
Phillip Engligh, Thomas Smythe and Chris McNeil, "The CalPERS Effect Revisited" (2004) 10 Journal of Corporate Finance 157.

[63] Bernard Black and John Coffee, "Hail Britannia? Institutional Investor Behavior under Limited Regulation" (1994) 92 Michigan Law Review 1994, 2038.

[64] 15 U.S.C. § 80a-22(e).

[65] John Morley, "The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation" (2014) 123 The Yale Law Journal 1228, 1246.

[66] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferrable Securities [2009] OJ L302/32, Article 84.
FCA Handbook Collective Investment Schemes (COLL) 6.2.16.

term, such as shareholder activism.[67] The liquidity concern also discourages open-ended funds from investing in assets which cannot be sold quickly or without discount, such as large amounts of shares. As shareholders' benefits from activism are mostly proportionate to their shareholdings, this disincentivizes open-ended funds against shareholder activism. Nevertheless, the liquidity concern is overrated. As argued by Illig, in practice end investors seldom withdraw assets from the funds. Given that the funds have large amounts of assets, their liquidity needs could be met with a small portion of assets, leaving them sufficient assets to engage in shareholder activism.[68]

Open-ended funds can also remove this disincentive by switching to closed-ended funds. However, exit is end investors main protection against fund managers' agency problem. As will be discussed later, fund managers have agency problems, or incentives to pursue private benefits rather than maximizing the funds' returns. Most end investors are unable or unwilling to monitor the behavior of fund managers. Hence they value their ability to exit funds whose performance suggests high agency costs.[69] Empirical studies did find that closed-ended funds traded at discounts. For example, Bradley *et al* found that closed-ended funds traded at 20% below their net asset value while open-ended funds had no discount.[70] Therefore, open-ended funds would only switch to closed-ended funds when such big discount could be made up by returns from shareholder activism. Portfolios of mainstream institutional investors are characterized by Boss *et al* as broad and shallow.[71] The funds hold hundreds, even thousands of companies, but their positions are seldom larger than 5%.[72] This suggests that rather than being a disincentive against

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[67] See Chapter 5.

[68] Robert Illig, "What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Oversight" (2007) 57 American University Law Review 225, 295.

[69] Morley, supra note 65, 1264.

[70] Michael Bradley, Alon Brav, Itat Goldstein and Wei Jiang, "Activist Arbitrage: A Study of Open-Ending Attempts of Closed-End Funds" (2010) 95 Journal of Financial Economics 1, 10.

[71] David Boss, Brian Connelly, Robert Hoskisson and Laszlo Tihanyi, "Corporate Governance: Ownership Interests, Incentives and Conflicts" in Mile Wright, Donald Siegel, Kevin Keasey and Igor Filatotchev (eds) *The Oxford Handbook of Corporate Governance* (OUP, 2013), 254.

[72] Ravi Dharwadkar, Maria Goranova, Pamela Brandes and Raihan Khan, "Institutional Ownership and Monitoring Effectiveness: It's Not Just How Much But What Else You Own" (2008) 19 Organization Science 419, 428.

shareholder activism, liquidity is actively chosen by the funds over activism, although the choices are influenced by legal rules.[73] The result, namely wide diversification, creates further disincentives against shareholder activism.

2. Externalities

Institutional shareholders' wide diversification means that their decisions on activism are not only influenced by its effect on target companies, but also by its effect on other portfolio companies.

First of all, target companies' improved performance might have negative effect on their competitors. Suppose increased productivity as a result of shareholder activism leads the company to reduce sale prices for its products. This induces consumers to switch to the company's products, reducing the profits of the company's competitors. For shareholders who have stakes in both the target company and its competitors, they only have incentives to engage in activism when their returns from the target company outweigh their losses in its competitors. But mainstream institutional investors seldom have shareholdings large enough to make this possible. Hence for widely diversified institutional investors, gains from one portfolio company are most likely to be offset by losses in another.[74] Given that shareholder activism is costly itself, mainstream institutional investors have little incentive to engage in activism on firm-specific issues.

Meanwhile, target companies' improved performance as a result of shareholder activism might prompt other companies to adopt similar practices. Other companies might also implement practices advocated by activist shareholders to fend off similar activism.[75] Widely diversified institutional shareholders can take advantage of this phenomenon by publicizing their activism and by introducing practices with wide application. This is indeed the case in practice. For example, Del Guercio and

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[73] See Chapter 6.
[74] Iman Anabtawi, "Some Skepticism about Increasing Shareholder Power" (2006) 53 UCLA Law Review 561, 583.
[75] See Chapter 4.

Hawkins found that public pension funds with wider diversification had stronger tendencies to publicize their activism, such as by publishing shareholder proposals in the Wall Street Journal.[76] Romano studied shareholder proposals which were mostly submitted by public pension funds in the US and found that they focused on general corporate governance issues, such as board independence and executive remuneration.[77] However, these strategies could be dangerous, as the effect of corporate governance practices are highly firm-specific.[78]

Widely diversified institutional investors often invest in the same companies. Since their performance is evaluated against the performance of other funds or certain indexes, institutional shareholders' decisions on activism are not only affected by their own costs and benefits from activism, but also by those of other funds.[79] Suppose two mutual funds loosely track an index. One is under-weighted in the company in question compared to the index while the other is over-weighted. When the first mutual fund's performance is compared to the index or to the performance of the over-weighted fund, it has no incentive to engage in activism even when its benefits from activism outweigh the costs, because the over-weighted fund would receive more benefits from activism at no cost. In fact, the first mutual fund might have incentive to support value-decreasing actions in the company, as doing so would make the over-weighted fund worse off.[80] This problem is more acute for mutual funds and insurance companies which face intense competition based on relative performance.[81]

Recent years have seen a trend towards indexation. Instead of actively picking stocks, more and more institutional investors invest passively by tracking certain

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[76] Diane Del Guercio and Jennifer Hawkins, "The Motivation and Impact of Pension Fund Activism" (1999) 52 Journal of Financial Economics 293, 305.

[77] Roberta Romano, "Less is More: Making Institutional Investor Activism A Valuable Mechanism of Corporate Governance" (2001) 18 Yale Journal on Regulation 174, 192 & 204.

[78] See Chapter 4 and 5.

[79] Lucian Bebchuk, "The Agency Problems of Institutional Investors" (2017) 31 Journal of Economic Perspectives 89, 99.

[80] Ibid.

[81] Dorothy Shapiro Lund, The Case Against Passive Shareholder Voting, Coase-Sandor Working Paper Series in Law and Economics 846 (2017), Accessed on August 17, 2019 at <https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=2515&context=law_and_economics>, at 7.

indexes, such as S&P 500 and FTSE 350.[82] The number of quasi-indexers is also increasing, who loosely track indexes but go under-weighted or over-weighted in some companies.[83] The idea of indexation is built on the efficient capital market hypothesis.[84] As will be discussed in Chapter 3, if the market is strongly efficient, a company's share price will accurately and promptly reflect its value. Hence no one can outperform the market, only to mimic it, which is indexation. The market's level of efficiency remains a controversial issue in academia. But an increasing number of empirical studies have found that active funds did not outperform passive funds.[85] For example, Jensen observed that although active funds had higher returns than passive funds, their frequent buying and selling resulted in higher transaction costs. Active funds also charged higher management fees. After deducting these costs, end investors in active funds had the same, sometimes even lower returns than end investors in passive funds.[86] Similar studies fueled a sharp growth in indexation.

Indexation mitigates some problems but creates new ones. Secondary trading in the stock market can be considered a zero-sum game, where one investor's gains come from another's losses.[87] Since their trading creates no value but incurs transaction costs, passive investing mitigates social wastes. However, as will be argued in Chapter 3, the market is not strongly efficient. By trying to buy undervalued shares and sell overvalued ones, active investors move share prices closer to companies' fundamental value. The shift from active to passive investing could reduce market efficiency.[88] Moreover, the rise of indexation would reduce the amount

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[82] Patrick McCabe, The Shift from Active to Passive Investing: Potential Risks to Financial Stability, Harvard Law School Forum on Corporate Governance and Financial Regulation, Accessed on April 30, 2019 at <https://corpgov.law.harvard.edu/2018/11/29/the-shift-from-active-to-passive-investing-potential-risks-to-financial-stability/>.

[83] Brian Bushee, "Do Institutional Investors Prefer Near-Term Earnings over Long-Run Value?" (2001) 18 Contemporary Accounting Research 207, 214.

[84] Burton Malkiel, "Reflections on the Efficient Market Hypothesis: 30 Years Later" (2005) 40 The Financial Review 1, 3.

[85] Charles Stein, Active vs. Passive Investing, Bloomberg (December 4, 2017).

[86] Michael Jensen, "The Performance of Mutual Funds in the Period 1945-1964" (1968) 23 The Journal of Finance 389.

[87] Lawrence Harris, The Winners and Losers of the Zero-Sum Game: The Origins of Trading Profits, Price Efficiency and Market Liquidity, Accessed on April 30, 2019 at <http://www-bcf.usc.edu/~lharris/ACROBAT/Zerosum.pdf>, 8.

[88] Nan Qin and Vijay Singal, "Indexing and Stock Price Efficiency" (2015) 44 Financial Management

of capital available to companies which are not included in main indexes. These companies are most likely to be young and small, with greater needs for capital.[89] Thus excessive indexation could hinder the development of the corporate sector.

Indexed funds do not seek to outperform the market and have no incentive to engage in activism. Quasi-indexed funds only have incentives to engage in activism in companies where they are over-weighted. But on the bright side, indexed funds and quasi-indexed funds cannot exit problematic companies which are included in the indexes.[90] If they could be made more engaged shareholders, indexed funds and quasi-indexed funds would be more suitable guardians of corporate value than active funds which generally favour exit over voice. This is particularly the case given the continuing growth in indexation.

3. Conflicts of Interest

Some institutional investors have or seek to enter into other business transactions with their investee companies. Sponsors of corporate pension funds might have business relationships with target companies.[91] Insurance companies offer various insurance policies to their investee companies, such as insurance against workplace injuries and officers' liabilities. A number of mutual funds are subsidiaries of investment banks, which might provide the funds' investee companies with services such as consultancy on share issuance and acquisitions.[92] Managers of target companies can retaliate against shareholder activism by taking these businesses away. For example, Hewlett Packard employed Deutsche Borse as its investment bank in its acquisition of Compaq in 2002. DB's asset management division, as a shareholder of Compaq, voted against the acquisition. It changed its votes after HP exerted pressure

875, 875.

[89] Daniel Del Guercio, "The Distorting Effect of the Prudent-Man Laws on Institutional Equity Investments" (1996) 40 Journal of Financial Economics 31, 42.

[90] Ian Appel, Todd Gormley and Donald Keim, "Passive Investors, not Passive Owners" (2016) 121 Journal of Financial Economics 111, 113.

[91] Lori Verstegen Ryan and Margnerite Schneider, "Institutional Investor Power and Heterogeneity" (2003) 42 Business and Society 398, 402.

[92] Gerald Davis and E Kim, "Business Ties and Proxy Voting by Mutual Funds" (2007) 85 Journal of Financial Economics 552.

on DB.[93] Based on their vulnerability to managerial pressure, Brickley *et al* proposed that institutional investors can be categorized into three groups, pressure sensitive, pressure indeterminate and pressure resistant institutions.[94] Insurance companies offer a number of insurance policies to investee companies and are sensitive to managerial pressure. Different mutual funds and corporate pension funds are likely to be subject to varying degrees of managerial pressure and are pressure indeterminate institutions.[95] Public pension funds have no business tie with their investee companies and are resistant to managerial pressure. Pressure sensitive and pressure indeterminate institutional shareholders are likely to have weak incentives to engage in activism.

Since 2003, the SEC requires mutual funds to disclose their voting records.[96] The rule provides researchers with an opportunity to study whether mutual funds' voting is compromised by conflicts of interest. Ye found that mutual funds seldom voted against management's value-decreasing proposals.[97] At first brush, this suggests that mutual funds' conflicts of interest prevented them from being responsible shareholders. However, Ye also found that before the votes, mutual funds often had private meetings with the management and a large number of value-decreasing proposals were withdrawn as a result.[98] Thus, Ye concluded that although mutual funds' conflicts of interest discouraged them from public activism, they did not preclude activism altogether.[99] Meanwhile, Davis and Kim found that mutual funds did not vote differently on the same issue in companies where they had other businesses and in companies where they did not.[100] But instead of interpreting this as indication that mutual funds' voting was not distorted by their conflicts of

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[93] Jennifer Taub, "Able but not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights" (2009) 34 The Journal of Corporation Law 102, 122.
[94] James Brickley, Ronald Lease and Clifford Smith, "Ownership Structure and Voting on Anti-Takeover Amendments" (1988) 20 Journal of Financial Economics 267, 277.
[95] Brickley *et al* viewed mutual funds as pressure resistant. Ibid.
[96] SEC Rule on Shareholder Reports and Quarterly Portfolio Disclosure of Registered Investment Management, RIN 3235-AG64, Accessed on August 17, 2019 at <https://www.sec.gov/rules/final/33-8188.htm>.
[97] Pengfei Ye, On Investors' Ownership and Voting Decisions: Evidence from Mutual Funds, Accessed on April 30, 2019 at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1100362>, 4.
[98] Ibid.
[99] Ibid.
[100] Davis and Kim, supra note 92, 557.

interest, Davis and Kim argued that mutual funds, well aware that their voting would be scrutinized, managed to support the management in other ways. For example, they found that in companies where mutual funds had other businesses, voting on both management and shareholder proposals were reduced. But given passive shareholders' tendency to blindly vote for the management, this had a more devastating effect on activist shareholders than the management.[101] Therefore, both empirical studies show that conflicts of interest reduce mutual funds' incentives to engage in activism. The disincentive is likely to be stronger for pressure sensitive insurance companies.

4. The Agency Problem of Fund Managers

The previous parts examined institutional investors' incentives to engage in activism. But institutional investors delegate to a chain of intermediaries whose incentives might differ from theirs. Consider the case of a hypothetical pension fund whose assets are held by a custodian bank.[102] The fund's board of trustees employs an asset allocator to decide how many assets to be invested in specific asset classes, such as bonds, equities and real estates.[103] It contracts an investment consultant to recommend fund managers specializing in these asset classes and to evaluate their performance after they are hired.[104] Fund managers usually employ brokers to do research and to execute transactions.[105] Fund managers who specialize in corporate shares might hire proxy advisors to advise on the governance of portfolio companies.[106] The advantages and problems of the investment chain will be explored in Chapter 7. Since decisions on shareholder activism fall on fund managers, this part examines fund managers' incentives to engage in activism.

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[101] Ibid, 572.
[102] Barker and Chiu, supra note 38, 27.
[103] The Myners Review, supra note 41, para 3.3.
[104] Tim Jenkinson, Howard Jones and Jose Vicente Martinez, "Picking Winners? Investment Consultants' Recommendations of Fund Managers" (2016) 71 The Journal of Finance 2333, 2338
[105] Barker and Chiu, supra note 38, 27.
[106] David Larcker, Brian Tayan and James Copland, The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry, Harvard Law School Forum on Corporate Governance and Financial Regulation, Accessed on April 30, 2019 at <https://corpgov.law.harvard.edu/2018/06/14/the-big-thumb-on-the-scale-an-overview-of-the-proxy-advisory-industry/>.

Like corporate managers,[107] fund managers have agency problems, or incentives to pursue private benefits rather than maximizing the funds' returns.[108] This means that fund managers are only likely to engage in activism when it increases their private benefits, mostly in the form of remuneration. A typical fund manager of mainstream institutional investor receives 2% of the funds' asset value.[109] Even when shareholder activism increases the funds' returns, fund managers only have incentives to engage in activism when the funds' improved performance leads to expanding assets under management. Empirical studies were inconclusive on the relationship between funds' returns and the size of their assets. Ippolito studied actively managed mutual funds and found that every 100 basis points outperformance against the benchmark led to 0.90 percent more asset inflows. The correlation between fund underperformance and asset outflows was not as significant. Ippolito believed that since terminating ongoing plans would incur costs, end investors simply contributed new assets to outperforming funds instead of withdrawing assets from underperforming ones.[110] Other studies doubted end investors' ability to evaluate fund performance. A study conducted by the Financial Conduct Authority in the UK found that most end investors did not understand variable performance benchmarks employed by institutional investors.[111] Bailey *et al* observed that end investors' behavioural biases, such as overconfidence, often led them to choose worse performing funds.[112] The uncertainty between funds' performance and the size of their assets reduces fund managers' incentives to engage in activism.

This disincentive could be mitigated by rewarding fund managers for the funds' increased returns. However, as for corporate managers, this would also incentivize

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[107] See Chapter 3.

[108] Bernard Black, "Agents Watching Agents: The Promise of Institutional Investor Voice" (1992) 39 UCLA Law Review 811, 850.

[109] Marcel Kahan and Edward Rock, "Hedge Funds in Corporate Governance and Corporate Control" (2007) 155 University of Pennsylvania Law Review 1021, 1050.

[110] Richard Ippolito, "Consumer Reaction to Measures of Poor Quality: Evidence from the Mutual Fund Industry" (1992) 35 The Journal of Law and Economics 45, 61.

[111] Financial Conduct Authority, Asset Management Market Study: Final Report MS 15/2.3 (July 2017), Accessed on September 14, 2019 at <https://www.fca.org.uk/publication/market-studies/ms15-2-3.pdf>.

[112] Warren Bailey, Alok Kumar and David Ng, "Behavioral Biases of Mutual Fund Investors" (2011) 102 Journal of Financial Economics 1, 16.

fund managers to manipulate the funds' performance and to take excessive risks.[113] But unlike corporate performance for which the share price is a reliable proxy, fund performance is more difficult to evaluate, especially for retail investors. Hence fund managers of retail investment funds in the US are only allowed to charge symmetric performance fees. This means that fund managers who share the funds' profits must also share its losses.[114] Empirical studies did find that symmetric performance fees effectively controlled fund managers' risk-taking.[115] Meanwhile, the UK allows fund managers to be rewarded for increases in the funds' returns with no penalty for decreases. But it regulates more closely how fund performance is measured and how fees are structured.[116]

Fund performance is influenced by many factors which are beyond the control of fund managers. Fund managers would only be willing to base their remuneration on fund performance if they are compensated for bearing these risks.[117] Meanwhile, investors are only likely to pay such premiums when fund managers with performance-based fees can produce higher returns than fund managers with fixed-amount of fees. In practice, fund managers of retail investment funds rarely charge performance-based fees.[118] This suggests that fund managers generally prefer low fees and shareholder passivity over activism.

IV. Hedge Fund Activism

Pension funds, insurance companies and mutual funds manage assets on behalf of public investors and can be characterized as public equity funds or retail investment funds.[119] As general public investors do not have expertise and wealth to

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[113] See Chapter 3.
[114] 15 U.S. C. § 80b–5.
[115] Laura Starks, "Performance Incentive Fees: An Agency Theoretic Approach" (1997) 22 Journal of Financial and Quantitative Analysis 17, 21.
[116] Financial Conduct Authority, Asset Management Market Study-Further Remedies PS19/4 (February 2019), Accessed on August 21, 2019 at
< https://www.fca.org.uk/publication/policy/ps19-04.pdf>, [4.2].
[117] See Chapter 3.
[118] Kahan and Rock, supra note 109, 1052.
[119] Illig, supra note 70, 228.

understand and bear risk, public equity funds are subject to various legal rules with investor protection as one of their objectives.[120] In contrast, private equity funds, such as hedge funds, leveraged buyout funds and venture capital funds, manage assets for commercially sophisticated and wealthy investors. Many private equity funds require minimum contribution of $1 million.[121] Because investors in private equity funds are presumed to be able to protect themselves, private equity funds are exempted from most legal rules on investment funds and are free to invest in all kinds of financial products using various methods. Venture capital funds take large positions in startups, work closely with management and profit by selling their shares when the companies go public.[122] Leveraged buyout funds buy controlling stakes in companies and take them private. The companies are floated back to the market after the funds manage to improve their performance. As leveraged buyout funds use leverage to purchase the companies' shares, they usually repay the debts by divesting the companies' assets.[123] Meanwhile, hedge funds invest in a wide range of markets, such as equities, bonds and commodities. They gain their names as they frequently use short selling and other securities derivatives to create hedges to limit their downside risks.

Hedge funds have much stronger incentives to engage in shareholder activism. Most hedge funds have lockup periods ranging from one to five years, during which time end investors cannot withdraw their assets from the funds.[124] Restricted liquidity does not decrease the funds' value because their end investors are more capable to monitor fund managers and assign less value to the ability to exit. Empirical studies even found that funds which gave their managers more discretion by having longer lockup periods had superior performance.[125] Since liquidity is not a concern, hedge funds have larger shareholdings in fewer companies. Hence hedge funds are less

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[120] Barker and Chiu, supra note 38, 51.
[121] Lynn Sherman, Hedge Fund Investing 101, Bloomberg (July 15, 2000).
[122] Susanne Espenlaub, Marc Goergen and Arif Khurshed, "Governance Implications of Locked-In Venture Capitalists and Founder Owners in Newly Floated UK Companies" in Igor Filatotchev and Mike Wright (eds) *The Life Cycle of Corporate Governance* (Edward Elgar, 2005) 99.
[123] Michael Jensen, Eclipse of the Public Corporation, Accessed on April 30, 2019 at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=146149 > , 7.
[124] The Economist, All Locked-Up (August 2, 2007).
[125] Phelim Boyle, Si Li and Yunhua Zhu, Hedge Fund Redemption Restrictions, Financial Crisis and Fund Managers, Accessed on August 21, 2019 at <https://pdfs.semanticscholar.org/1a64/07009f2a7847836c642864eb061449649b71.pdf>, 21.

influenced by the effect of shareholder activism on other portfolio companies. More importantly, the performance of hedge funds is evaluated on absolute terms.[126] This means that hedge fund activism is not affected by how it impacts other funds which invest in the company. Hedge funds do not provide corporate service and do not have conflicts of interest. In the US, fund managers of qualified investors are allowed to charge non-symmetric performance fees.[127] Qualified investors are those who have at least $1,000,000 under management or whose net worth exceeds $2,100,000.[128] A typical hedge fund manager charges 2% of asset under management and 20% of the funds' profits if performance targets are met.[129] Thus they have strong incentives to engage in activism to increase the funds' returns.

Hedge funds started to engage in shareholder activism in the 2000s[130] and transformed shareholder activism into an active investment strategy. Originally shareholder activism was defensive.[131] Investors purchased into a company out of the belief that its value would increase in the future. When unanticipated problems occurred, investors engaged in activism to protect the value of their investments. In contrast, activist hedge funds identify a company with problems and become shareholders of the company in order to engage in activism. They make profits by selling their positions after the problems are solved and the value of their shares has increased. As hedge funds are actively searching for targets, hedge fund activism is also called offensive shareholder activism.[132]

In recent years, the majority of shareholder activism campaigns have been initiated by hedge funds. But mainstream institutional investors have shown willingness to join in the effort afterwards. This is likely to be caused by the accelerating model of increased shareholder voice and the success of shareholder activism. Research on the relationship between the input of resources and the

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[126] Kahan and Rock, supra note 109, 1064.
[127] 15 U.S. C. § 80b–5.
[128] 17 C.F.R. § 275.205–3.
[129] Kahan and Rock, supra note 109, 1064.
[130] Brian Cheffins and John Armour, The Rise and Fall (?) of Shareholder Activism by Hedge Funds, ECGI Law Working Paper No 136/2009, Accessed on August 21, 2019 at <https://ecgi.global/sites/default/files/working_papers/documents/SSRN-id1489336.pdf>, 23.
[131] Ibid, 2.
[132] Ibid, 3.

production of public goods remains inconclusive. When the notion of public good was first developed, the relationship between input and output was assumed to be linear. Under this model, if the production of a public good requires an investment of £100, an investment of £1 will increase the probability of its production by 1%, regardless of when the investment is made. Later researchers argued that the model might be accelerating, decelerating or a hybrid of both. Under the accelerating model, an additional investment has greater effect on the production of the public good than an earlier investment of the same amount.[133] Using the above example, suppose the first £10 creates a 10% probability that the public good will be provided. The second £10 might increase the probability by 20% and the third by 40%. The opposite will work in the decelerating model. As to shareholder activism, although management might be able to dismiss the voice of one or two shareholders, it becomes harder with more activist shareholders. Hence the relationship between increased shareholder voice and the success of shareholder activism is likely to be accelerating. With hedge funds bearing the initial costs by starting shareholder activism, mainstream institutional shareholders have stronger incentives to be engaged as their potential returns from doing so increase. The presence of hedge funds as offensive activist shareholders has also encouraged mainstream institutional investors to take actions which, although cannot change the management directly, signal agency problems to hedge funds, such as by voting against executive remuneration.[134] Thus the presence of activist hedge funds increases the incentives of mainstream institutional shareholders to engage in activism, although overall their incentives remain weak.

V. Conclusion

This chapter introduces the current landscape of shareholder activism and its

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[133] Pamela Oliver, Gerald Maxwell and Ray Teixeira, "A Theory of the Critical Mass I Interdependence, Group Heterogeneity and the Production of Collective Action" (1985) 91 American Journal of Sociology 522, 526

[134] Ekrem Solak, "Evolving Role of Shareholders and the Future of Director Primacy" (University of Edingburg 2018)

causes to serve as the foundation for future legal reforms. It finds that mainstream institutional investors and their fund managers generally prefer passivity and exit over shareholder activism as an investment strategy. This has resulted in wide diversification which further discourages shareholder activism. Unlike other mainstream institutional investors, public pension funds do not have conflicts of interest, which partly explains why they tend to be more active. Hedge funds do not have liquidity concerns or conflicts of interest. Their relatively concentrated portfolios and absolute performance evaluation make them less concerned about the externalities of shareholder activism. Hence hedge funds have strong incentives to engage in activism. Performance-based remuneration also aligns hedge fund managers' incentives with the funds' and the current landscape of shareholder activism is dominated by hedge funds.

The rise of hedge fund activism changed the image of shareholder activism. In the 1990s, most commentators regarded shareholder activism as a beneficial corporate governance mechanism. But as hedge funds often appear to be aggressive and frequent traders, their activism is heavily criticized for being opportunistic and myopic.[135] Chapter 4 will assess the economic effect of shareholder activism in detail. But before that, Chapter 2 will introduce how shareholders can engage in activism and Chapter 3 will decide how the economic effect of shareholder activism should be assed.

[135] See Chapter 4.

Chapter 2 Legal Frameworks of Shareholder Activism in the US and the UK

This chapter introduces how shareholders can engage in activism by examining the division of power between the board and shareholders in the US and the UK. The previous chapter studied economic disincentives against shareholder activism and put great emphasis on the costs of activism. This chapter illustrates this point by discussing the difficulties shareholders face when they take actions against corporate management. This chapter finds that shareholders in the UK have stronger power than their counterparts in the US. Its effect on shareholder activism will be discussed in later chapters.

This chapter is organized as follows. Section I introduces regulatory competition in the US and the EU which might affect the division of corporate power. Section II examines directors' duties which limit the power of directors. Section III studies directors' duties in takeovers. Section IV analyzes how shareholders can enforce directors' duties by bringing derivative actions. Section V looks at shareholder information rights and how they can enforce the rights by bringing securities fraud litigation. Section VI studies how shareholders can engage in activism using their voting rights, including the right to remove directors, to submit shareholder proposals and to vote on fundamental corporate issues. Section VII concludes.

I. Regulatory Competition

In the US, a company is governed by company law of the state of its incorporation. As companies pay franchise taxes to their states of incorporation, it is generally assumed that all states have incentives to attract incorporation. This results in an incorporation competition between the states. The winner of the competition is Delaware, with more than half of America's public companies incorporated there.[1] Hence this thesis focuses mainly on Delaware company law.

Opinions are divided on whether incorporation competition is beneficial to

[1] Mark Roe, "Delaware's Competition" (2003) 117 Harvard Law Review 588, 588.

shareholders. As managers decide where to incorporate, it is reasonable to suspect that they would choose the state with the most pro-management corporate law, making the incorporation competition a race to the bottom.[2] One often-cited example of the race to the bottom is the small number of incorporations in California, which is extraordinary as California holds the highest number of corporate headquarters in the US. The cause of this phenomenon is believed to be California's pro-shareholder law. For example, in the 1990s, California adopted several pro-takeover rules, including a shareholder equality rule which practically invalidates poison pills.[3] Afterwards a significant number of Californian companies reincorporated in Delaware.[4]

Other commentators argued that in an efficient market, the value of a company's choice of law would be reflected in the company's share price. As investors would pay lower prices for companies which provide shareholders with little power, even self-interested managers have incentives to incorporate in states with shareholder-friendly law to avoid problems arising from a low share price. Hence the incorporation competition is a race to the top. Several empirical studies have lent support to this argument by finding that companies incorporated in Delaware have the highest market value.[5]

As will be discussed in Chapter 3, the market is not strongly efficient. Thus the incorporation competition does decrease shareholder value to some extent. But the relatively efficient market also prevents incorporation competition from being a race to the very bottom. For example, it has been noted that Pennsylvania failed in the incorporation competition because of its extreme anti-takeover statutes, one of which requires unsuccessful bidders to disgorge short-term profits made by selling the target's shares.[6] Many companies in Pennsylvania opted out of the statute or reincorporated in other states, presumably out of fear that being overly against

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[2] William Cary, "Federalism and Corporate Law: Reflections Upon Delaware" (1974) 83 The Yale Law Journal 663, 680.
[3] California Corporations Code § 203.
[4] Guhan Subramanian, "The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the Race Debate and Antitakeover Overreaching" (2002) 150 University of Pennsylvania Law Review 1795, 1854.
[5] Ibid, 1808.
[6] Pennsylvania Corporations and Unincorporated Associations § 2575.

takeovers would send negative signals to the market.[7]

Meanwhile, although Scotland has certain autonomous legislative power, the UK has almost a unitary company law system. There is some level of regulatory competition within the EU, but its scale is not comparable to the competition in the US. Many EU member states, such as Germany, France and the Netherlands, adopt the real seat doctrine, under which a company is governed by the law of the nation where it conducts its principal business, or where its real seat is.[8] Other member states, notably the UK, adopt the incorporation doctrine, under which a company is governed by the law of the nation of its incorporation.[9] This difference makes only one way of the regulatory competition possible. For example, a company with its principal business in Germany can incorporate in the UK and be governed by its company law. But the legal status of a company which is incorporated in Germany with its principal business in the UK would be recognized in neither country. Because in the UK there is no minimum capital requirement for private companies and the costs for incorporation are lower than in most member states, a number of companies with their principal business in the Continent chose to incorporate in the UK.[10] This has prompted some member states to reform their company law. But the UK is unlikely to be Delaware in the EU. Delaware is a small state with no major industry, making the bar a powerful interest group. As more incorporations bring more legal disputes and more benefits to the bar, it lobbied policymakers to introduce rules which attract incorporations.[11] For bigger states with major industries, labour is amongst the most powerful interest groups. Rather than winning the incorporation competition, labour cares more about protecting workers' interests, which is why many large states, such as Pennsylvania, has highly anti-takeover laws. As sovereign states have more interest groups, attracting incorporation is unlikely to be a priority. This is especially

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[7] Subramanian, supra note 4, 1857.

[8] Marco Ventoruzzo, Cost-Based and Rule-Based Regulatory Competition: Markets for Corporate Charters in the US and the EU, Legal Studies Research Paper No 14, Accessed on September 6, 2019 at < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=946730>, at 26.

[9] Ibid.

[10] Marco Becht, Colin Mayer and Hannes Wagner, "Where Do Firms Incorporate? Deregulation and the Cost of Entry" (2008) 14 Journal of Corporate Finance 241, 242.

[11] Geoffrey Miller, "Political Structure and Corporate Governance: Some Points of Contrast between the United States and England" (1998) Columbia Business Law Review 51, 53.

the case since the EU does not allow member states to put taxes on the mere act of incorporation, removing one major incentive for incorporation competition.[12] Moreover, in the US, corporate tax and securities laws are part of federal law. A company's decision on which state to incorporate is based purely on the merits of company law. Meanwhile, each EU member state has its own tax and securities laws. A company has to consider how a nation's company law fits with another nation's wider legal framework.[13] Not to mention cultural and language barriers. Hence companies in the EU have relatively weak incentives to incorporate overseas. Finally, the Second Company Law Directive mandates minimum capital for public companies across the EU,[14] which removes most of the charm of the UK's law for public companies.[15] As this thesis focuses on listed companies, incorporation competition in the EU is irrelevant.

II. Directors' Duties

Directors owe certain duties to their companies. If the duties prescribe high standards of conduct and are strongly enforced, there would be little agency problem and no need for shareholder activism. This section briefly introduces the duties and how stringent they are.

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[12] Martin Gelter, "The Structure of Regulatory Competition in European Corporate Law" (2005) 5 Journal of Corporate Law Studies 247, 259.
[13] Ibid, 265.
[14] Directive 2012/30/EU of the European Parliament and of the Council of 25 October 2012 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 54 of the Treaty on the Functioning of the European Union, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent [2012] OJ L315/74, Article 54.
[15] Becht *et al*, supra note 10, 250.

1. Delaware

(1)Duty of Loyalty and Duty of Care

Although there had been some confusion, it became clear that directors in Delaware have two core duties, duty of loyalty and duty of care.[16] The duty of loyalty requires directors to act in good faith in the best interests of the company.[17] In the famous Michigan case of *Dodge v Ford*, Dodge brothers, as minority shareholders in Ford, sued the company's director and majority shareholder Henry Ford for withholding dividends.[18] Ford argued that he withheld dividends to pay employees better salaries and to produce cars at lower prices.[19] The Supreme Court of Michigan ordered dividends to be paid, stating that directors' primary duty was to make profits for shareholders.[20] But *Dodge v Ford* does not preclude directors' from promoting stakeholder interests. As Stout argued, Ford withheld dividends to deny Dodge brothers funds to set up a rival automobile company. The court ruled against Ford not because he pursued other stakeholders' interests, which could be in the company's interests, but for acting for improper purpose.[21] *Shlensky v Wrigley* supported the view that directors are free to pursue interests of other stakeholders as long as doing so benefits shareholders. The company in this case operated a baseball team and its home park. Its minority shareholder wanted the home park to be open for night games and sued the directors for breach of duties after they refused to do so.[22] The Appellate Court of Illinois ruled that there was nothing suggesting improper motives behind the

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[16] In *Cede*, the Supreme Court of Delaware claimed that there is a triad of directors' duties: duty of loyalty, care and good faith. Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993) at 361.
Following this judgment, academics such as Eisenberg argued that the duty of good faith is an independent duty. See Melvin Eisenberg, "The Duty of Good Faith in American Corporate Law" (2006) 3 European Company and Financial Law Review 1, 20.
This view was rejected in *Stone v Ritter*, where Delaware Supreme Court ruled that the duty of good faith is subsidiary of the duty of loyalty. Stone v Ritter 911 A.2d 363 (Del. 2006) at 370.
[17] American Bar Association, Model Business Corporation Act (2003), §8.30(a).
[18] Dodge v Ford Motor Co 170 N.W.668 (Mich. 1919) at 670.
[19] Ibid, 671.
[20] Ibid, 684.
[21] Lynn Stout, "Why We should Stop Teaching Dodge v Ford" (2008) 3 Virginia Law and Business Review 163, 167.
[22] Shlensky v Wrigley 95 Ill. App 2d 173 (Ill. App. Ct. 1968) at 175.

directors' decisions. It surmised that the directors decided against having night games because it would have deteriorating effect on the neighbourhood which would not be in the company's interests in the long term.[23] The court ruled that it would not interfere with directors' decisions unless there was fraud, illegality or conflict of interest.[24]

Many States have constituency statutes which explicitly allow directors to pursue stakeholder interests.[25] Delaware does not have a corporate constituency statute. But directors are still free to promote the benefits of other stakeholders as long as doing so is in shareholders' interests.[26] The exception is when the Revlon duty is triggered, which will be discussed in the next section. Directors can take creditors' interests into account when the company is of doubtful solvency.[27] But creditors' interests are subordinated to shareholders' interests.[28] When the company is insolvent, creditors replace shareholders as residual claimants and are sole beneficiaries of directors' duties.[29]

The duty of loyalty prohibits directors from having private interests which conflict with their duties to the company.[30] In *Guth v Loft*, Guth as a director of Loft, used Loft's facilities, credit and employees to develop Pepsi, a company in which he held shares.[31] The Supreme Court of Delaware ruled that the opportunity to invest in Pepsi belonged to Loft. The previous owner of Pepsi only came to Guth because of his position in Loft, a retailer which could introduce Pepsi to new markets.[32] The opportunity was of interests to Loft because at the time it was finding cheaper cola to sell.[33] Loft also had the financial resources to pursue the opportunity.[34] Therefore

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[23] Ibid, 181.
[24] Ibid.
[25] Indiana Business and Other Associations § 23-1-34-1(d).
[26] Unocal Corp v Mesa Petroleum Co 493 A.2d 946 (Del. 1985) 955.
[27] Production Resources v NCT Group 863 A.2d 772 (Del. Ch. 2004) at 788.
[28] Royce Barondes, Lisa Fairfax, Lawrence Hamermesh and Robert Lawless, "Twilight in the Zone of Insolvency: Fiduciary Duty and Creditors of Troubled Companies-History & Background" (2007) 1 Journal of Business and Technology Law 229, 243.
[29] Geyer v Ingersoll Publications Co 621 A.2d 784 (Del. Ch. 1992).
[30] Guth v Loft 5 A.2d 503 (Del. 1939) at [48].
[31] Ibid, [24].
[32] Ibid, [58].
[33] Ibid, [56].
[34] Ibid, [62].

Guth's interests in Pepsi belonged to Loft.[35]

Following *Guth v Loft*, directors can pursue opportunities if they were acquired independently of the company and that the company did not have valid interests in the opportunities. In *Broz v Cellular Information Systems*, Broz was director of both CIS and RFBC. The owner of a license to offer cellular service considered CIS financially incapable of acquiring the license and offered the opportunity to Broz as a director of RFBC.[36] After CIS's CEO and two directors expressed no interest in the license, Broz caused RFBC to purchase the license.[37] CIS was later acquired by PriCellular and sued Broz for usurping the corporate opportunity.[38] As Broz did not come to the opportunity in his fiduciary capacity, the issue was whether CIS had valid interests in the opportunity. The Supreme Court of Delaware ruled that the issue must be judged on the circumstances at the time, without considering PriCellular's subsequent acquisition.[39] The court found that CIS agreement with its creditors prevented it from acquiring new assets.[40] Due to financial difficulties, it was actually divesting similar licenses.[41] Thus CIS did not have valid interests in the opportunity.

Directors are also subject to the duty of care. Around the time *Smith v Van Gorkom* was decided, the US experienced an insurance crisis, where insurance against liabilities of directors and officers had high premiums and small coverage.[42] Delaware legislature believed that *Smith v Van Gorkom* contributed to the crisis by raising the standard of care.[43] It responded by introducing Section 102(b)(7) into its company law, which allows companies to exempt directors from breach of care in their articles of association.[44]

The duty of care is an objective duty, requiring directors to exercise care of an

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[35] Ibid, [70].
[36] Broz v Cellular Information Systems Inc 637 A.2d 148 (Del. 1996) at 150.
[37] Ibid, 152.
[38] Ibid, 153.
[39] Ibid, 156.
[40] Ibid, 155.
[41] Ibid, 156.
[42] Roberta Romano, "Corporate Governance in the Aftermath of the Insurance Crisis" (1990) 39 Emory Law Journal 1155, 1155.
[43] Jay Brown and Sandeep Gopalan, "Contractarians, Waiver of Liability Provisions and the Race to the Bottom" (2009) 42 Indiana Law Review 285, 302.
[44] Delaware General Corporation Law § 102(b)(7).

ordinary prudent man.[45] Although the duty of loyalty is primarily a subjective duty, it also has an element of objectivity, requiring directors' decisions to be rational.[46] However, as argued by Eisenberg, these standards of conduct are different from the standard of review.[47] Delaware has three standards of review, the highest of which is the entire fairness test, which applies to directors with conflicts of interest. The intermediate standard is enhanced scrutiny, which applies to directors of takeover targets. The lowest standard is the business judgment rule, which applies to all other circumstances.

(2)The Business Judgment Rule

The business judgment rule is "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[48] Under the protection of the business judgment rule, courts will not review directors' decisions.[49] Those alleging directors' breach of duties have the burden of proof to raise serious doubts as to directors' performance of the duties.

The business judgment rule can be rebutted by showing that directors are grossly negligent. In *Smith v Van Gorkom*, Van Gorkom, CEO and chairman of Trans Union, based on a report prepared by the company's CFO, decided that $55 per share was a fair price to sell a controlling stake in the company. Accordingly he reached a merger agreement with Pritzker which was approved by the board and a majority of shareholders.[50] The issue was whether the board's approval was made on an informed basis. The board made three arguments on its due care, all of which were rejected by the Supreme Court of Delaware. First, the board argued that the fact that it deliberated

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[45] American Law Institute, Principles of Corporate Governance: Analysis and Recommendations (1992) § 4.01.
[46] American Bar Association, Model Business Corporation Act §8.30(a).
[47] Melvin Eisenberg, "The Divergence of Standards of Conduct and Standards of Review in Corporate Law" (1993) 62 Forham Law Review 437, 441.
[48] Aronson v Lewis 473 A.2d 805 (Del. 1984) at 812.
[49] Stephen Bainbridge, "The Business Judgment Rule as Abstention Doctrine" (2004) 57 Vanderbilt Law Review 83, 95.
[50] Smith v Van Gorkom 488 A.2d 858 (Del. 1985) at 870.

for four months and held three meetings over the merger demonstrated its diligence.[51] While this argument was accepted by the Chancery Court, the Supreme Court found that the decision on the merger was made in the first meeting. Subsequent meetings were only held to deal with problems arising from the merger. Hence whether the board's approval of the merger was made on an informed basis had to be decided based on the decision-making process in the first meeting.[52] In the first meeting, the board decided that the price was fair based on two types of evidence, the first of which included Van Gorkom's presentation and the study prepared by the CFO. The court ruled that although directors can rely on employee reports, neither document qualified. Van Gorkom did not read the merger agreement before his presentation to the board and the CFO's report was not prepared specifically for valuation purposes.[53] The board also argued that it believed the merger price to be fair because it offered a premium to the market price.[54] The court noted that market prices were sometimes depressed. Although this did not preclude using premiums to justify mergers and acquisitions, other methods of valuation should have been employed.[55] Second, after the merger was approved, it was subjected to market test for 90 days. According to the board, the fact that there was no higher bidder proved the fairness of the merger price.[56] The Supreme Court rejected this argument as it found that certain items in the merger agreement, such as a deadline for third party bidders to come up with definite merger agreements, precluded a public auction.[57] Third, the board argued that since a majority of shareholders approved the merger, any breach on its part weas ratified.[58] The Supreme Court found that shareholders' approval was not given on an informed basis because the board did not disclose material information such as how the merger price was reached to.[59] Therefore, the board was grossly negligent, the business

[51] Ibid, 873.
[52] Ibid, 874.
[53] Ibid.
[54] Ibid, 875.
[55] Ibid
[56] Ibid, 878.
[57] Ibid.
[58] Ibid, 889.
[59] Ibid, 890.

judgment rule was rebutted and the board was found in breach of the duty of care.[60]

The business judgment rule can also be rebutted by showing directors' bad faith. Directors are in bad faith if they act irrationally[61] or for purposes other than the betterment of the company.[62] Wasting corporate assets is one example. In *In re Walt Disney,* the employment of Michel Ovitz as President of Disney was terminated and he departed with severance payments worth $130 million.[63] Shareholders brought a derivative action against Ovitz and the board. They claimed that by approving Ovitz's employment agreement, the board was grossly negligent[64] and wasted corporate assets, both of which showed bad faith.[65] Ovitz was believed to be in breach of duty by accepting the payments.[66] Ovitz's employment agreement entitled him to severance payments if his employment was terminated without cause. The Supreme Court of Delaware ruled that since Ovitz did not influence the decision to terminate his employment without cause, he did not breach the duty of loyalty by accepting the severance payments.[67] With regards to the board's approval of the employment agreement, the issue was whether it was aware of all material information, notably the magnitude of the severance payments.[68] The court found that remuneration packages of other managers and Ovitz's remuneration paid by his former employer all informed the board on the scale of the severance payments.[69] Thus although its decision-making process fell short of best practices,[70] the board was not grossly negligent.[71] The court also clarified that gross negligence alone is not bad faith. Breach of the duty of care only translates into bad faith when directors intentionally derelict the duty. In that case the breach cannot be exempted by Section 102(b)(7).[72]

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[60] Ibid, 893.
[61] Brehm v Eisner 746 A.2d 244 (Del. 2000) at 264.
[62] Clark Furlow, "Good Faith, Fiduciary Duties and the Business Judgment Rule in Delaware" (2009) Utah Law Review 1061, 1072.
[63] In re Walt Disney Co. Derivative Litigation 906 A.2d 27 (Del. 2006) at 34.
[64] Ibid, 63.
[65] Ibid, 46.
[66] Ibid, 49.
[67] Ibid, 50.
[68] Ibid, 56.
[69] Ibid, 57.
[70] For example, not all directors read the employment agreement.
[71] Disney, supra note 63, 58.
[72] Ibid, 63.

Corporate wastes refer to transactions which have inadequate consideration and cannot be attributed to rational business purposes.[73] In this case the severance payments were not corporate wastes because the company was contractually obligated to pay and there was a rational purpose for the payments. Therefore the business judgment rule applied to the board's approval of the severance payments.

The connection between breach of care and bad faith was confirmed in *Stone v Ritter*. The company in question, AmSouth Bank, did not have effective anti-money laundering systems and was fined for its involvement in a Ponzi scheme.[74] Shareholders brought a derivative action against the directors without demanding the board to act first. As will be discussed later, demand could only be excused when a majority of the board cannot decide disinterestedly on the suit, or in other words, when a majority of the board are likely to be liable for breach of duties. As AmSouth exempted directors from breach of care, the board would only be personally interested in the suit when its failure in monitoring constituted bad faith.[75] The Supreme Court of Delaware ruled that breach of care would only be translated into bad faith when the breach was intentional and sustained.[76] The court found that the directors did not consciously disregard their oversight duties because there were systems in AmSouth to prevent money laundering.[77] The systems were inadequate, but absent grounds for suspicion, the board was justified to rely on the system.[78] Thus the board did not act in bad faith and shareholders' claim was dismissed. By linking sustained dereliction of the duty of care to bad faith which cannot be exempted, *Disney* and *Stone v Ritter* prompt directors to discharge their duty to monitor more diligently.[79]

Directors who cause the company to violate the law are not protected by the business judgment rule, even when they honestly believe that doing so is in the company's interests. In *Roth v Robertson*, the company operated an amusement park.

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[73] Ibid, 74.
[74] Stone v Ritter 911 A.2d 362 (Del. 2006) at 367.
[75] Ibid.
[76] Ibid, 372.
[77] Ibid, 371.
[78] Ibid, 368.
[79] Clark Furlow, "Good Faith, Fiduciary Duties and the Business Judgment Rule in Delaware" (2009) Utah Law Review 1061, 1078.

A large part of its revenue was generated on Sundays, but the law of the state did not allow amusement parks to open on Sundays. The defendant director paid those who intended to report the company $800 for their silence.[80] The illegality rebutted the business judgment rule and the director was order to repay the company $800.[81]

(3)Entire Fairness

Directors and controlling shareholders who stand on both sides of the transaction are subject to the entire fairness standard, which requires them to prove both fair dealing and fair price.[82] But the substantive prong of the standard is increasingly diminished by the procedural prong.[83] In *Kahn v Lynch Communication Systems*, Alcatel Corporation held 43% of Lynch's shares. Lynch's charter required mergers to be approved by 80% of shares. When Lynch attempted to merge with Telco, Alcatel stated that it would not approve the merger unless Lynch first considered merging with Celwave, a company associated with Alcatel.[84] Lynch formed an independent committee to consider a merger with Celwave but eventually decided against it.[85] Alcatel then offered to acquire control of Lynch at $15.50 per share. The independent committee considered the price inadequate. Alcatel threatened that if the offer was rejected, it would go hostile with a lower price. This led the independent committee to approve Alcatel's acquisition.[86] The Supreme Court of Delaware ruled that if Alcatel could prove fair dealing, that the acquisition was approved either by independent directors in arm's length negotiations or an informed majority of disinterested shareholders, the burden of proof would be shifted to shareholders to prove the unfairness of the price.[87] But the court found that Alcatel failed to show fair dealing

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[80] Roth v Robertson 64 Mics. 343 (N. Y. Misc. 1909) at 344.
[81] Ibid, 345.
[82] Kahn v Lynch Communication Systems 638 A.2d 1110 (Del. 1994) at 1115.
[83] Amir Licht, Farewell to Fairness: Towards Retiring Delaware's Entire Fairness Review, ECGI Law Working Paper No 439/2019, Accessed on May 9, 2019 at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3331097>, 2.
[84] Kahn v Lynch, supra note 82, at 1112.
[85] Ibid, 1113.
[86] Ibid.
[87] Ibid, 1117.

because the independent committee did not possess real bargaining power. Its approval of Alcatel's acquisition, like its decision to abandon the merger with Telco, was dictated by Alcatel, not its independent judgment.[88] Hence the burden of proof remained with Alcatel to prove the entire fairness of the acquisition.

In *Kahn v M&F Worldwide Corp*, M&F, entirely owned by Ronald Perelman, held 43% of MFW's shares. Its merger with MFW was approved by both an independent committee and a majority of minority shareholders.[89] The Supreme Court of Delaware ruled that if M&F could prove the independence of both the committee and the shareholders, its self-dealing would be protected by the business judgment rule.[90] Appellant shareholders argued that three members of the independent committee had other business relationships with M&F and were not independent.[91] The argument was rejected by the court, as the court found that the compensation the directors received for the other businesses was not material and was unlikely to influence their judgment.[92] The shareholders also argued that the independent committee did not have real bargaining power because M&F's large shareholdings make merger with other companies highly improbable.[93] The court found that the independent committee had considered other options, such as asset divestures, but decided that merger with M&F was the best course.[94] M&F's original offer was $24 per share. The committee's financial adviser valued MFW's share value at $22-$45 per share.[95] The independent committee counter offered at $30 per share. The price was settled at $25 per share.[96] Judged on these events, the court decided that the independent committee had real bargaining power and exercised due care in negotiating the merger.[97] As the board disclosed details of valuations and its negotiation with M&F to shareholders, the court ruled that the approval of

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[88] Ibid, 1119.
[89] Kahn v M&F Worldwide Corp 88 A.3d 635 (Del. 2014) at 638.
[90] Ibid, 644.
[91] Ibid, 647.
[92] Ibid.
[93] Ibid, 650.
[94] Ibid.
[95] Ibid, 652.
[96] Ibid .
[97] Ibid, 653.

disinterested shareholders was given on an informed basis.[98] Therefore, the business judgment rule applied.

2. UK

Case law in the UK formulated two directors' duties, the fiduciary duty of loyalty and the common law duty of care. The Companies Act 2006 codified the duties and stipulated other duties under the two umbrellas.

The core of the duty of loyalty is codified in section 172, the duty to act in good faith to promote the success of the company. The success of the company is interpreted as the benefits of shareholders as a whole.[99] But directors should also have regard to stakeholder interests if doing so benefits shareholders.[100] As it was colourfully put in *Hutton v West Cork Railway Company*, "the law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company."[101] When a company is in a state of doubtful solvency, directors' duties are owed both to shareholders and creditors.[102] Directors' duties are owed solely to creditors when insolvency is inevitable.[103]

Directors who honestly believed that they acted in the companies' best interests would not be held in breach of the duty of loyalty even when their decisions appear to be unreasonable to courts.[104] In *Charterbridge Corporation v Lloyds Bank*, two companies, Castleford and Pomeroy were members of a corporate group. Each held the other's shares.[105] Castleford guaranteed and paid for a portion of Pomeroy's debts.[106] In doing so, directors of Castleford only considered the interests of the corporate group, not the interests of Castleford. The court ruled that when directors

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[98] Ibid.
[99] Companies Act 2006, section 172(1).
[100] Andrew Keay, *The Enlightened Shareholder Value Principle and Corporate Governance* (Routledge, 2013), 105.
[101] Hutton v West Cork Railway Company (1883) 23 Ch. D. 654, 673.
[102] Andrew Keay, "The Shifting of Directors' Duties in the Vicinity of Insolvency" (2015) 24 International Insolvency Review 140, 143.
[103] Companies Act 2006, section 172(3).
[104] Re Smith and Fawcett, Limited [1942] Ch 304, 306.
[105] Chaeterbridge Corporation Ltd. v Lloyds Bank Ltd [1970] Ch. 62, 66.
[106] Ibid, 67.

did not consider the effect of their decisions on the company, courts should ask whether an intelligent honest man in the same position would reasonably believe that doing so is in the company's interests.[107] The court found that Pomeroy was essential to Castleford's performance of a £25,000 contract. Thus a hypothetical director would find supporting Pomeroy in the company's interests and the directors did not breach the duty of loyalty to the company.[108]

Courts are not obligated to believe directors' claim of good faith. In *Extrasure Travel Insurance Ltd v Scattergood*, two directors of Extrasure transferred £200,000 of corporate assets to its parent company, Inbro Holdings. Inbro transferred the money to its other subsidiary Citygate which was in financial distress.[109] The directors claimed that the transfer was a repayment of debts.[110] They also argued that Citygate's liquidation would increase Extrasure's costs, pushing it towards insolvency.[111] Hence in either way they acted in the best interests of Extrasure. Nevertheless, the court found that the directors could not honestly believe that they were acting in Extrasure's interests. The court found that when other directors questioned the transfer, the defendant directors did not explain it as repayment of debts.[112] Instead they promised that the money would be repaid in a few days.[113] Hence it was clear that at the time of the transfer, the directors did not regard it as repayment of debts. The court also found that the directors did not honestly believe in Citygate's turnaround or its repayment of the £200,000. The directors talked about Citygate's prospect of receiving £500,000 and other business opportunities. But in the court's opinion, they never really expected them to materialize.[114] Thus the court stated that the directors made the transfer because Citygate needed the money, without considering the interests of Extrasure.[115] Following *Charterbridge*, the court inquired on whether a hypothetical director would believe that the directors acted in the

[107] Ibid, 74.
[108] Ibid.
[109] Extrasure Travel Insurance Ltd v Scattergood [2003] BCLC 598 at [21].
[110] Ibid, [103].
[111] Ibid, [114].
[112] Ibid, [104.3].
[113] Ibid, [104.4].
[114] Ibid, [119], [121].
[115] Ibid, [137].

company's interests and reached a negative answer.[116]

A subsidiary duty of the duty of loyalty is the duty not to have personal interests which conflict with the interests of the company.[117] In *Regal Hasting v Gulliver*, Regal Ltd wanted to acquire leases of two cinemas. Regal set up a subsidiary, Amalgamated, which would own the leases. Amalgamated issued 5,000 shares with nominal value of £1.[118] According to its original plan, Regal would subscribe for 2,000 of the shares and its directors would give joint guarantee for the rent.[119] One director, Gulliver, was unwilling to give such guarantee. In order to ensure the owner of the cinemas that Amalgamated would be able to pay the rents, the other four directors and Regal's solicitor each subscribed for 500 of the shares. Gulliver found a buyer for the remaining 500 shares.[120] Control of Regal was later changed and Regal sued the directors and the solicitor for diverting corporate opportunities. The court ruled that whether the directors acted in good faith or whether the company could have taken the opportunities were irrelevant.[121] The only factor that mattered was that the directors and the solicitor became aware of the opportunity and profited from it in their fiduciary capacities.[122] Thus the solicitor and the directors, except Gulliver who did not profit from the opportunity, were ordered to account for the profits.[123]

Bhullar v Bhullar adopted a more restrictive approach. In *Bhullar v Bhullar*, two brothers and their family members were directors and shareholders of a company operating grocery stores. After the relationship between the two families broke down, the board decided to divide the company's assets and not to acquire new property.[124] The defendant directors then discovered and purchased a piece of land in their private capacities.[125] Following *Regal*, the court ruled that whether the company had any

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[116] Ibid, [139].
[117] Companies Act 2006, section 175.
[118] Regal (Hastings) Ltd v Gulliver [1967] 2 AC 134, 140.
[119] Ibid, 141.
[120] Ibid, 142.
[121] Ibid, 144.
[122] Ibid, 145.
[123] Ibid, 150.
[124] Bhullar v Bhullar [2003] EWCA Civ 424 at [10].
[125] Ibid, [11].

intent in exploiting the opportunity was irrelevant.[126] But unlike *Regal*, the court ruled that directors have one capacity and one capacity only. Hence the fact that the directors discovered the opportunity in their private capacities did not absolve them of liabilities.[127] Since the land was adjacent to the company's property, the opportunity would be commercially appealing to the company. Thus the directors breached their duties by taking the opportunity without asking the company to act first.[128] As argued by Kershaw, the non-conflict duty transformed a proscriptive duty not to take corporate opportunities to a prescriptive duty to inform the company of attractive opportunities.[129] It is over-restrictive and discourages directors from identifying valuable business opportunities.[130]

Section 177 and section 182 require directors to disclose interests in proposed and existing transactions. Substantial interested transactions must be approved by ordinary resolutions.[131] A transaction is substantial if its value exceeds 10% of the company's asset value and is more than £5000, or if its value exceeds £100,000.[132] Companies' loans to their directors must be approved by ordinary resolutions.[133] For directors of public companies, quasi-loans must also be approved.[134] Quasi-loans refer to payments the company made for expenses incurred by its directors while the directors promise to reimburse the company.[135] Directors of public companies are also not allowed to enter into credit transactions with the companies without shareholder approval.[136]

The duty of care under section 174 requires a director to exercise care that can be reasonably expected from a person in her position and to the best of her expertise. This standard of care has some elements of objectivity. In *Re D'Jan of London Ltd*, a

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[126] Ibid, [41].
[127] Ibid.
[128] Ibid.
[129] David Kershaw, *The Foundations of Anglo-American Corporate Fiduciary Duties* (Cambridge University Press, 2018) 411.
[130] John Lowry and Rod Edmunds, "The Corporate Opportunity Doctrine: The Shifting Boundaries of the Duty and its Remedies" (1998) 61 Modern Law Review 515, 535.
[131] Companies Act 2006, section 190.
[132] Ibid, section 191 (2).
[133] Ibid, section 197.
[134] Ibid, section 198.
[135] Ibid, section 199.
[136] Ibid, section 201.

director filled a fire insurance form without reading the questions. It turned out that he answered some questions untruthfully which allowed the insurance company to deny payments when the company was damaged by fire.[137] The court held that directors who had limited time and expertise were not obligated to read all documents. But one would reasonably expect the director to read a simple yet important insurance contract.[138] Thus the director breached his duty of care.

But the standard of care is a primarily subjective standard. In *Norman v Theodore Goddard*, a director of a company controlled by a trust fund, acting on the advice of a trustee, transferred corporate assets to an offshore company to avoid paying taxes on interest. It later turned out that the offshore company was controlled by the trustee who misappropriated the money.[139] The court ruled that a director in the defendant's position was not reasonably expected to have expertise in tax or company law.[140] He could rely on the expertise of others on these matters, but could not blindly follow their advice.[141] Before deciding to transfer the money, the director asked the trustee whether the recipient company was also controlled by the trust fund to ensure the safety of the assets.[142] The director also asked whether transferring the money offshore would be more profitable than depositing it domestically and whether the company could promptly withdraw the money.[143] Although the trustee's answers were lies, there was nothing at the time to suggest that the director's reliance on his advice was unreasonable.[144] Therefore the director did not breach the duty of care.

Directors' duty of care also encompassed a duty to monitor. In *Baker v Secretary of State for Trade and Industry*, Barings Bank went insolvent because of its losses in derivatives trading incurred by Leeson, a trader in the bank's Singapore branch. Directors of Barings were disqualified and one director, Baker, challenged the

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[137] Re D'Jan of London Ltd [1993] BCC 646, 647.
[138] Ibid, 648.
[139] Norman v Theodore Goddard [1992] BCC 14, 14.
[140] Ibid.
[141] Ibid, 18.
[142] Ibid.
[143] Ibid.
[144] Ibid, 23.

decision in court.[145] The court found that Leeson controlled both the front and back office of the division. Hence he was able to record his own trading, park losses in other accounts to inflate profits and make large bets, which led the bank to insolvency.[146] Baker knew about Leeson's role in both offices and asked Leeson to resign from either office. But he did not check on whether Leeson acted as he asked.[147] The court ruled that directors should ensure that there are systems of internal control within the company.[148] Although absent grounds for suspicion, directors can rely on these systems, they should act when they believe there are problems.[149] Thus Baker was in breach of care.

As the scope of corporate opportunities is much broader in the UK and directors cannot contract around the duty of care, directors in the UK are subject to more stringent duties than their counterparts in Delaware. But even in the UK, directors' duties only set low standards for directorial behavior. This calls for other corporate governance mechanisms.

III. Takeovers

Directors of target companies frequently lose their jobs after takeovers. This makes takeover a powerful corporate governance mechanism and whether directors should be able to frustrate takeovers an important issue concerning directors' duties.

1. Delaware

Directors whose primary motive is to impede shareholder voting in non-takeover situations are subject to the Blasius standard. In *Blasius Industries Inc v Atlas Corporation*, Atlas Corp, as shareholder of Blasius, submitted a proposal to restructure the company and to elect eight more directors. Blasius had a staggered

[145] Baker v Secretary of State for Trade and Industry [2001] B.C.C 271, 275.
[146] Ibid, 278.
[147] Ibid, 287.
[148] Ibid, 283.
[149] Re City Equitable Fire Insurance Co [1925] Ch. 407, 429.

board with seven directors. The appointment of eight more directors would change control of the board.[150] The board responded immediately by adding two friendly directors to the board.[151] Delaware Chancery Court found that the timing of the board's action suggested that its primary motive was to impede shareholder voting to change board control.[152] As the incumbents' positions were not threatened, the board did not act self-interestedly.[153] But as shareholder disenfranchisement was involved, good faith could not absolve the board of liabilities. The board must demonstrate compelling justifications for doing so.[154] The board argued that it acted to prevent shareholders from being coerced into approving value-decreasing restructuring.[155] The court ruled that although this argument would be valid to business decisions, it did not apply to this present case, as the matter to be voted on was election of directors.[156] The court found that the proposal of Atlas, a 9% shareholder, was not coercive. It gave the board sufficient time to persuade other shareholders.[157] Thus there was no compelling justification for the board to disenfranchise shareholders.

Directors of takeover targets can take defensive measures if they satisfy the two Unocal tests. In *Unocal Corp v Mesa Petroleum Co*, Mesa, a company holding 13% of Unocal's shares made a two-tier offer to Unocal's shareholders. The first tier offer was a cash offer for 37% of Unocal's shares at $54 per share. The second tier offer would exchange each remaining share with debt securities worth $54.[158] Unocal's board valued the company at at least $60 per share. The board also concluded that the debt securities offered by Mesa were highly subordinated and were worth less than $54. Hence the board sought to frustrate the takeover by implementing a share repurchase plan, which would be triggered if Mesa completed its first tier offer.[159] Under the plan, Unocal would buy back the remaining shares with debt securities

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[150] Blasius Industries Inc v Atlas Corporation 564 A.2d 651 (Del.Ch. 1988) at 654.
[151] Ibid, 655.
[152] Ibid, 656.
[153] Ibid, 658.
[154] Ibid, 662.
[155] Ibid, 663.
[156] Ibid.
[157] Ibid.
[158] Unocal Corp v Mesa Petroleum Co, 493 A.2d 946 (Del 1985), 949.
[159] Ibid, 950.

worth $72.[160] The Supreme Court of Delaware ruled that as directors' private interests in the preservation of their jobs are strong in takeovers, target boards must be subject to enhanced judicial scrutiny, which involves two tests.

First, there must be "reasonable grounds for believing that a danger existed to corporate policy and effectiveness by another's share ownership".[161] Target boards can satisfy this test by proving its good faith and reasonable investigation. Proof would be enhanced if the decisions are made by a majority of independent directors.[162] Unocal's board argued that Mesa's two-tier offer would force shareholders to accept the inadequate first-tier offer out of the fear that they would be left with debt securities with even lower value.[163] Meanwhile, Mesa contended that Unocal's board acted in bad faith, as the implementation of the share repurchase plan resulted in the board's shares being bought at a premium.[164] Unocal's board argued, to the acceptance of the court, that the primary motive for the share repurchase plan was either to frustrate the first-tier bid, or upon its completion, to compensate remaining shareholders.[165] The fact that the board had collateral benefits from the action did not suggest its bad faith. Thus the board satisfied the first test. The second Unocal test required defensive measures to be reasonable and proportionate to the threats posed, which was the case for Unocal's board.[166]

Both Unocal tests were relaxed in later cases. In *Paramount Communications Inc v Time inc*, Paramount made an offer for Time after Time had reached a merger agreement with Warner. Time sought to frustrate the takeover by restructuring the merger as an acquisition of Warner. As Time would assume a large amount of debt to finance the acquisition, it would become an unappealing target for Paramount.[167] Paramount's claim against Time was based on two grounds. First, in reaching a merger agreement with Warner, Time's board triggered its Relvon duty and thus could

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[160] Ibid, 951.
[161] Ibid, 955.
[162] Ibid.
[163] Ibid, 956.
[164] Ibid, 957.
[165] Ibid, 956.
[166] Ibid, 955.
[167] Paramount Communications Inc v Time Inc 571 A.2d 1140 (Del 1989) 1148.

not reject Paramount's higher offer.[168] Second, as Paramount's offer was a negotiable all-cash-all-share offer, it could not pose any danger to Time.[169] The court found that in negotiating a merger with Warner, Time's board did not intend to break up or change control of the company. In fact, Time successfully negotiated to take control of the merged entity. Hence the Revlon duty was not triggered.[170] The court also stated that all-cash-all-share offers could pose threats to target companies. In this specific case, the threat was that Paramount's offer could be deliberately timed to frustrate a merger between Time and Warner. Shareholders might tender to Paramount in ignorance of the long-term value created by the Time-Warner merger.[171] Thus Time satisfied the first Unocal test.[172] The *Paramount* decision is significant. It expanded the scope of reasonable threats from inadequate or coercive offers to disruption to targets' business plans. It essentially gave target boards the power to "just say no" to hostile takeover.[173]

The proportionality test was also relaxed in later cases. In *Unitrin Inc v American General Corp*, Unitrin satisfied the first prong of Unocal by identifying two dangers posed by American General's offer. Unitrin successfully argued that the offer was inadequate. There were also risks that the acquisition could not be completed due to anti-trust concerns.[174] Unitrin's charter required business combinations with shareholders holding more than 15% of its shares to be approved by either 75% of shareholders or a majority of the board.[175] To block the takeover, the board introduced a share repurchase plan which would increase its shareholding from 23% to 28%.[176] The Chancery Court of Delaware ruled that the share repurchase plan would allow the board to preclude the takeover and thus was excessive to the threats posed.[177] This ruling was reversed by the Supreme Court. The court reasoned that

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[168] Ibid.
[169] Ibid, 1149.
[170] Ibid, 1150.
[171] Ibid, 1153.
[172] Ibid, 1155.
[173] Ronald Gilson, "Just Say No to Whom" (1990) 25 Wake Forest Law Review 121, 121.
[174] Unitrin Inc v American General Corp 651 A.2d 1361 (Del. 1995) at 1375.
[175] Ibid, 1377.
[176] Ibid.
[177] Ibid.

even when the board held 28% of the shares, American General could still win a proxy fight to change the majority of the board.[178] Hence defence is reasonable as long as it does not make winning proxy fights "mathematically impossible or realistically unattainable."[179] However, as argued by Edelman and Thomas, mathematically possible success might not be attainable in practice.[180] Leaving this ambiguity problem aside, later cases' application of *Unitrin* showed that the proportionality test is unlikely to be demanding.

In *Versata v Selectica*, the target company, Selectica, held net operating loss carry forwards (NOLs), which would result in tax refunds when the company made taxable profits but would lose value upon the company's change of control.[181] To protect its NOLs, the company sought to frustrate Versata's offer by lowering the trigger of its poison pill from 15% to 4.99%.[182] When Versata's share ownership exceeded 4.99%, the positions of other shareholders were doubled, which diluted Versata's stake.[183] The Supreme Court of Delaware held that Selectica satisfied the first prong of the Unocal tests.[184] The issue was whether the unusually low trigger of Selectica's poison pill, in combination with its staggered board, would preclude Versata from winning the proxy fight.[185] Versata argued that limiting its shareholding to such a small stake would make winning the proxy fight extremely difficult.[186] Meanwhile, the court found that 55% of Selectica's shares were held by 7 shareholders. In this case the success of the proxy fight would depend more on Versata's ability to convince these shareholders on the merits of the offer rather than on the size of its shareholding.[187] Selectica's defensive measure only made the takeover more difficult, not impossible. Thus it satisfied the proportionality test.

In addition to the two *Unocal* tests, target board might also be subject to the

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[178] Ibid, 1383.
[179] Ibid.
[180] Paul Edelman and Randall Thomas, "Selectica Resets the Trigger on the Poison Pill: Where should the Delaware Courts Go Next?" (2012) 87 Indiana Law Journal 1087, 1105.
[181] Versata v Selectica 5 A.3d 586 (Del. 2010) at 589.
[182] Ibid, 584.
[183] Ibid, 598.
[184] Ibid.
[185] Ibid, 604.
[186] Ibid, 601.
[187] Ibid, 605.

Revlon duty. In *Revlon Inc v MacAndrews&Forbes Holdings Inc,* to frustrate an inadequate offer from Pantry Pride, Revlon implemented a Note Rights Plan which would be triggered once Pantry Pride's share ownership exceeded 20%. Revlon also repurchased 10 million shares with notes with a 11.75% interest rate which would mature in ten years.[188] Revlon then negotiated to sell the company to Forstmann. However, a rumor of the redemption of the notes was spread and the notes' price plummeted. In response to the fury of noteholders and their threats to sue, Revlon's directors made supporting the notes' value a condition of the transaction. In exchange, the Revlon board agreed to a no-shop provision and a lock-up provision according to which two Revlon divisions would be sold to Forstman if another bidder acquired 40% of its shares.[189] The court found that Revlon satisfied the two Unocal tests. But when Revlon started to find third party buyers, it became apparent that changing control of the company was inevitable. Since it was shareholders' last chance to realize share value, the board had an auctioneer duty to secure the highest price for the shareholders, without considering the interests of other stakeholders.[190] The court found that Revlon's board failed to fulfill this duty by signing the non-shop provision and agreeing not to find bidders other than Forstman. With regard to the lock-up provision, the court ruled that it can be employed in order to lure more bidders into the auction. But since Forstman was already engaged in negotiations, Revlon's board breached the auctioneer duty by agreeing to the lock-up provision.[191]

2. UK

Takeovers in the UK are governed by the Takeover Code.[192] The Code is drafted and enforced by the Takeover Panel. The Panel was a self-regulatory organization. But following the Takeover Directive,[193] the Panel was given a statutory status.[194]

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[188] Revlon Inc v MacAndrews&Forbes Holdings Inc 506 A.2d 173 (1986), 177.
[189] Ibid, 178.
[190] Ibid, 182.
[191] Ibid.
[192] The Takeover Panel, City Code on Takeovers and Mergers (September 12, 2016).
[193] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover

Principle 3 and Rule 21 of the Code prevent target boards from frustrating takeovers without shareholder approval once takeovers are imminent, commonly known as the non-frustration rule.[195]

Directors are also subject to the duty under section 171 to act within power.[196] In *Hogg v Cramphorn*, the board issued shares to an employee trust in order to dilute the position of a hostile bidder. The court ruled that corporate power could only be used for its proper purpose and the proper purpose of share issuance was to raise capital, not to dilute a majority.[197] As argued by Kershaw, since it is impossible to specify each power's proper purpose, the proper purpose of directorial power is simply not to obstruct shareholder voting.[198]

Kershaw also correctly pointed out that most takeover defences would not be available in the UK even without the non-frustration rule.[199] For example, poison pills are the most commonly used takeover defences in the US. Poison pills are formally known as shareholder rights plans. With a pill in place, when a shareholder purchases a certain percentage of shares without the board's approval, the board can issue shares to other shareholders to dilute the acquirer's position.[200] As companies want to leave the possibility of friendly mergers open, most poison pills can be redeemed by the board. Thus a hostile bidder can launch a proxy fight to replace the board with a board which will redeem the pill. But most companies combine poison pills with staggered boards. As it typically takes two years to change control of staggered boards, this combination frustrates most takeovers.[201] In the UK, the proper purpose doctrine and shareholders' statutory right to remove directors render both poison pills and staggered boards unworkable.

The inability of the board to impede shareholder voting and to frustrate takeovers

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bids [2004] OJ L142/12, Article 1(1).

[194] Companies Act 2006, section 942.

[195] The Takeover Code, supra note 192, General principle 3 and Rule 21.1.

[196] The Companies Act 2006, section 171.

[197] *Hogg v Cramphorn* [1967] Ch 254, 268.

[198] David Kershaw, "The Illusion of Importance: Reconsidering the UK's Takeover Defence Prohibition" (2007) 56 International and Comparative Law Quarterly 267, 283.

199 Ibid, 273.

[200] Ibid, 272.

[201] Yakov Amihud, Markus Schmid and Steven Solomon, "Settling the Staggered Board Debate" (2018) 166 University of Pennsylvania Law Review 1475, 1480.

significant increases shareholder power.

IV. Derivative claims

1. Delaware

In Delaware, shareholders who wish to bring derivative actions must demand the company to act first.[202] Demand could be excused when shareholders show that the board is unlikely to make unbiased decisions on the suit. In *Aronson v Lewis,* shareholders argued that the remuneration of one director, Fink, was so excessive that it amounted to corporate waste.[203] They brought a derivative action against the board without demanding the board to act first. The shareholders argued that demand would be futile because the board was controlled by Fink who held 47% of the company's shares and appointed the other directors.[204] The shareholders also argued that since the directors were defendants, they were personally interested in the outcome of the suit, which disabled them from making disinterested judgment on the suit.[205] The Supreme Court of Delaware ruled that directors would not be deemed non-independent merely because they were appointed by a specific shareholder, approved the transaction in question or were defendants in the suit.[206] To establish demand futility, the shareholders had to show substantial probabilities of the directors' breach of duties, which the shareholders failed to do in the present case.[207]

Shareholders can bring derivative actions if the board's refusal to litigate is wrongful. In *Biondi v Scrushy,* certain directors of HealthSouth sold the company's shares before releasing negative information to the market. The company set up a litigation committee after several derivative actions were brought. The litigation committee petitioned Delaware Chancery Court to stay these actions until it could

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[202] Zapata Corp v Maldonado 430 A.2d 779 (Del. 1981) at 784.
[203] Aronson v Lewis 473 A.2d 805 (Del. 1984) at 808.
[204] Ibid, 809.
[205] Ibid.
[206] Ibid, 810, 817.
[207] Ibid, 815.

decide on whether litigation was in the company's best interests.[208] The court ruled that normally stay would be granted to allow litigation committees sufficient time to investigate. But it was clear that the litigation committee in the case could not judge independently. It did not have full power and the board could move to dismiss the derivative actions without its approval.[209] One wrongdoing director was on the committee. Another member of the committee served on the board of a foundation with a wrongdoing director. The positions were meaningful to both of them.[210] The chairman of the litigation committee even publicly cleared the directors of wrongdoing before the committee finished investigation.[211] As the committee was likely to wrongfully dismiss the derivative actions, its petition was denied by the court.

2. UK

In the UK, the issue of shareholder litigation against directors' breach of duties was originally settled in *Foss v Harbottle*. In *Foss v Harbottle*, the company's directors sold their land to the company. Minority shareholders asked the court to nullify the transaction.[212] The court ruled that only the company can sue against a wrong done to the company. As a majority of shareholders could avoid or ratify the transaction, minority shareholders should not be allowed to sue in the name of the company.[213] Minority shareholders could only sue in the company's stead when wrongdoers are in control or when the majority's decision not to sue constitutes fraud on the minority.[214] As emphasis was put on whether the breach could be ratified, common law derivative actions were restricted to breach of loyalty.[215]

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[208] Biondi v Scrushy 820 A.2d 1148 (Del. Ch. 2003), 1148.
[209] Ibid.
[210] Ibid.
[211] Ibid.
[212] Foss v Harbottle (1843) 2 Hare 461, 494.
[213] Ibid, 503.
[214] David Kershaw, The Rule in Foss v Harbottle is Dead; Long Live the Rule in Foss v Harbottle, LSE Law, Society and Economy Working Papers 5/2013, Accessed on September 15, 2019 at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2209061 >, at 2.
[215] Christopher Riley, "Derivative Claims and Ratification: Time to Ditch Some Baggage" (2014) 34

Except for multiple derivative actions, the Companies Act 2006 replaced common law derivative actions with statutory derivative actions. The new regime no longer restricts derivative actions to breach of loyalty. It prescribes a two-stage process for shareholders to gain court permission to bring derivative actions.

First, shareholders must establish a *prima facie* case of directors' breach of duties.[216] As directors are not involved at this stage, shareholders only need to demonstrate that the suit is not frivolous.[217] At the second stage, a full hearing would be commenced. The court must dismiss the case if a person acting in accordance with section 172 would not pursue the suit or when the breach has been authorized or ratified.[218] Absent these two circumstances, courts will decide whether to allow derivative actions to proceed based on several factors, including whether the shareholders acted in good faith, the importance a director under section 172 would attach to the suit, the likelihood of ratification, whether the company has decided not to sue and whether there are alternative remedies.[219]

In *Iesini v Westrip Holdings Ltd*, Barnes and Walker were controlling shareholders of Rimbal, a company with a valuable exploration license. Westrip reached an agreement with Barnes and Walker to buy their shares in Rimbal with redeemable preference shares in Westrip.[220] At the time all parties considered the deal completed, but in fact Westrip's articles of association did not allow it to issue redeemable preference shares.[221] Believing that it held the license, Westrip entered into a joint venture with GGG. When the board of the joint venture discovered the problem with the redeemable preference shares, it concluded that it had no choice but to redeem the shares and return the shares in Rimbal to Barnes and Walker.[222] Rimbal replaced Westrip in the joint venture. Iesini, a shareholder of Westrip, brought a

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Legal Studies 583, 591.

[216] Companies Act 2006, section 261(2).

[217] Andrew Keay and Joan Loughrey, "Something Old, Something New, Something Borrowed: An Analysis of the New Derivative Action Under the Companies Act 2006" (2008) Law Quarterly Review 469, 482.

[218] Companies Act 2006, section 263(2).

[219] Ibid, section 263 (3).

[220] Iesini v Westrip Holdings Ltd [2010] B.C.C 420, 424.

[221] Ibid, 425.

[222] Ibid, 432.

derivative action against the board of the joint venture.[223]

The court concluded that no director acting in accordance with section 172 would pursue the suit, because the board sought counsels' advice before redeeming the shares and did not act negligently or fraudulently.[224] Even though the suit was dismissed, the court went on to consider the issue of good faith. Iesini's legal expenses were indemnified by GGG which wanted to get out of the joint venture and Iesini promised to consult GGG before taking any material steps.[225] The court ruled that this did not constitute bad faith. When a derivative action is brought partly for the benefit of the company, partly for other purposes, plaintiff shareholders would only be held in bad faith when "but for the collateral purpose, the claim would not have been brought at all."[226] However, the court found that the redemption of the shares was only necessary because directors of Westrip, including Iesini, did not exercise its due diligence in the issuance of the shares. As Iesini contributed to the wrong, he could not be the proper plaintiff in this suit.[227]

In *Franbar Holdings Ltd v Patel*, Franbar held 25% and Casualty Plus held 75% of shares in Medicentres. The two shareholders had an agreement to each appoint two directors and that Casualty had call options on Franbar's shares.[228] Franbar sought permission to bring a derivative action against directors appointed by Casualty, accusing them of diverting the company's business to Casualty in order to drive down the market price for Casualty to exercise its options.[229] The court found that Franbar had established a *prima facie* case of the directors' breach of duties. Since the act was not ratified, the court only considered whether a hypothetical director would pursue the case. Recognizing that different directors would conclude differently on the issue, the court ruled that it would only dismiss the action at this stage when no hypothetical director would pursue the action, which was unlikely in the present case.[230] The court

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[223] Ibid, 433.
[224] Ibid, 444.
[225] Ibid, 446.
[226] Ibid, 448.
[227] Ibid, 449.
[228] Franbar Holdings Ltd v Patel [2008] EWHC 1534 (Ch) 889.
[229] Ibid.
[230] Ibid, 894.

then considered several factors.

First, whether the breach could be ratified. Section 239 of the Companies Act 2006 allows directors' breach of duties to be ratified by a majority of shareholders, without counting the votes of directors and their connected persons. The court found that although the directors were appointed by Casualty, there was no evidence that Casualty controlled the directors.[231] But as the directors were accused of diverting business from the company to Casualty, Casualty should not vote on the matter. Thus the act could not be ratified.[232]

Second, whether Franbar acted in good faith. The directors argued that Franbar's motive in bringing the derivative action was to force Casualty to buy its shares at a premium. The fact that Franbar rejected its fair offer was indication of its bad faith.[233] The court agreed that Franbar's objective was to exit the company and had indeed brought unfair prejudice proceedings to seek this end. But the court did not consider Franbar acted in bad faith. Rather, it ruled that because personal remedies were available to Franbar, a hypothetical director would not attach much importance to the continuation of the action and dismissed the action.[234]

In *Kleanthous v Paphitis*, Paphitis was a director of RGL and controlled another company, Xunely. He usurped RGL's opportunity by having Xunely take the opportunity. He also made RGL extend loans to Xunely. Paphitis's actions were approved by three other directors of RGL, who also had interests in Xunely.[235] After a derivative action was brought, RGL set up a committee comprising its CEO and CFO and decided not to continue the action.[236] Shareholders argued that the CEO and the CFO held board positions in companies which were associated with Paphitis and were not independent. This argument was rejected by the court as the CEO and the CFO were not involved in the transactions in question. The court ruled that the committee, under the advice of legal counsels, was better placed than the court to decide on the

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[231] Ibid, 897.
[232] Ibid, 898.
[233] Ibid.
[234] Ibid, 894.
[235] Kleanthous v Paphitis [2011] EWHC 2287 (Ch) at [32].
[236] Ibid, [74].

continuation of action. Thus it attached considerable weight to the committee's decision and dismissed the action.[237]

By removing wrongdoer control and fraud on minority as prerequisites of derivative claims, the new regime seeks to facilitate derivative actions. However, as argued by Reisberg, the new regime still attaches significant weight to the likelihood of ratification, which is essentially asking whether wrongdoers are in control.[238] Moreover, the importance a hypothetical director would attach to the continuation of the action is essentially a business decision. Courts are generally reluctant to make such business decisions and are deferential to the companies' decisions. This resulted in permissions being granted sparingly. For example, Keay found that in the decade after the implementation of statutory derivative actions, only 36% of derivative actions gained court permission to continue.[239]

Although both jurisdictions set high bars for the bringing of derivative actions, there were fewer derivative actions in the UK than in Delaware.[240] One explanation is that the UK did not allow lawyers to charge contingency fees, reducing their incentives to represent plaintiff shareholders.[241] This problem was mitigated as the UK legalized contingency fees in 2012.[242] But the UK still has a loser-pay rule, which requires the losing party to pay for the other party's litigation expenses. The rule serves as a significant disincentive against derivative actions.[243] More importantly, shareholders in the UK have more power than shareholders in Delaware. This means that more disputes could be settled internally, rather than relying on costly and time-consuming litigation.[244]

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[237] Ibid, [75].
[238] Arad Reisberg, "Shadows of the Past and Back to the Future: Part 11 of the UK Companies Act 2006 (in)action" (2009) 6 European Company and Financial Law Review 219, 230.
[239] Andrew Keay, "Assessing and Rethinking the Statutory Scheme for Derivative Actions under the Companies Act 2006" (2016) 16 Journal of Corporate Law Studies 39, 54.
[240] John Armour, Bernard Black, Brian Cheffins and Richard Nolan, "Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States" (2009) 6 Journal of Empirical Legal Studies 687, 699.
[241] Ibid, 692.
[242] Legal Aid, Sentencing and Punishment of Offenders Act 2012, section 45.
[243] Armour *et al*, supra note 240, 692.
[244] Iris Chiu, "Reviving Shareholder Stewardship: Critically Examining the Impact of Corporate Transparency Reforms in the UK" (2014) 38 Delaware Journal of Corporate Law 983, 992.

V. Shareholder Information Rights

The success of shareholder activism depends on how much information shareholders have. The law mitigates information asymmetry between shareholders and the management by mandating corporate disclosure and by giving shareholders rights to demand information. Investors can also bring legal actions against corporate misstatements.

1. Mandatory Corporate Disclosure

In the US, securities law requires companies to disclose related-party transactions (transactions between companies and their directors, officers and shareholders) worth more than $120,000.[245] Companies with assets worth more than $10 million or with more than 2000 investors must register with the SEC and be subject to the Securities Act of 1933 and the Securities Exchange Act of 1934.[246] The 1934 Act requires companies to prepare audited annual reports by filing Form 10K with the SEC.[247] Companies are also required to file unaudited quarterly reports (Form 10Q) with the SEC.[248] When material information arises, companies must publicly disclose the information by filing Form 8-K within four business days.[249]

In the UK, for each financial year, all companies must prepare annual accounts, including a balance sheet and a profit and loss statement.[250] Directors, except those in micro-companies,[251] must prepare directors' reports, where matters of significance

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[245] SEC Standard Instructions for Filing Forms under Securities Act of 1933, Securities Exchange Act of 1934 and Energy Policy and Conservation Act of 1975 (Regulation S-K), codified at 17 C.F.R. Part 229.
17 C.F.R. § 229.404.
[246] SEC Rules and Regulations under Securities Exchange Act of 1934, codified at 17 C.F.R Part 240.
17 CFR § 240.12g.
[247] SEC Forms under Securities Exchange Act of 1934, codified at 17 C.F.R Part 249.
17 C.F.R § 249.310.
[248] 17 C.F.R § 249.308.
[249] 17 C.F.R § 249.308.
[250] Companies Act 2006, section 396.
[251] Ibid, section 415(1A).

are narrated.[252] Directors, other than those in small companies[253] must prepare strategic reports,[254] where directors analyze how they have complied with section 172, to promote the success of the companies while having regard to other stakeholders.[255] Directors of quoted companies must prepare directors' remuneration reports, which disclose each director's remuneration.[256] All the documents, except those of small companies,[257] must be audited.[258] The documents, along with auditors' reports, must be filed with the registrar, where they could be accessed by the public.[259] Quoted companies must publicize the documents on their websites and ensure their availability until the publication of next year's documents.[260] All companies must circulate the documents to every member, every holder of debentures and every person who is entitled to receive notice of general meetings.[261] Members and debenture-holders can request for the most recent documents.[262] Directors of public companies must lay the documents in the general meetings.[263]

The UK implemented the Transparency Directive[264] mostly in the Financial Conduct Authority's Disclosure and Transparency Rules, which apply to listed companies.[265] Compared to company law rules,[266] the listing rules require speedier disclosure. The period allowed for the publication of annual accounts is four months

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[252] Ibid, section 415(3).
[253] A company is a small company if it satisfies two of the following requirements in one financial year: a turnover of no more than £10.2 million, no more than £5.1 million on balance sheet or no more than 50 employees, unless it is a public company, an investment company or a investment management company.
See section 382 and section 384 of Companies Act 2006.
[254] Companies Act 2006, section 414B.
[255] Ibid, section 414C.
[256] Ibid, section 421.
[257] Ibid, section 477.
[258] Ibid, section 495.
[259] Ibid, section 441.
[260] Ibid, section 430.
[261] Ibid, section 423.
[262] Ibid, section 431-432.
[263] Ibid, 437.
[264] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC [2004] OJ L390/38.
[265] FCA Handbook, Listing Rules 9.2.6A.
[266] The period allowed for companies to deliver the documents to the registrar is nine months after the end of the financial year for private companies and six months for public companies.
Companies Act 2006, section 442(2).

after the end of the financial year.[267] Other than financial statements and management reports, those who have managerial responsibilities are also required to sign and publicize responsibility statements.[268] The reports must be audited and auditors' reports must be publicized as well.[269] Listed companies must also publicize half-yearly reports, including simplified financial statements, management reports and responsibility statements.[270] Interim reports are not required to be audited.[271] Listed companies must also notify the Regulated Information Service as soon as material events occur.[272] The information must be posted on the company's website within one day of notification.[273]

2. Shareholders' Rights to Demand Information

Section 220 of Delaware General Corporation Law gives shareholders the right to inspect the company's books and records. However, case law has made clear that the section is not a permit for broad fishing expedition and shareholders must establish proper purpose of the demand.[274] The scope of inspection is also restricted to its purpose. For example, in *Melzer v CNET*, shareholders of CNET brought a derivative claim against the board for backdating options in the District Court of California. To establish demand futility, shareholders must show that a majority of the board were personally interested in the outcome of the suit.[275] Shareholders sought permission at Delaware Chancery Court to inspect the company's books and records to establish demand futility. Both sides agreed that this was a proper purpose.[276] The board argued that as the shareholders did not have standing to sue against wrongs done to the company before they invested in the company, they should not be able to

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[267] FCA Handbook, Disclosure and Transparency Rules 4.1.3.
[268] Ibid, 4.1.12.
[269] Ibid, 4.1.7.
[270] Ibid, 4.2.3.
[271] Ibid, 4.2.9.
[272] Ibid, 2.21.
[273] Ibid, 2.3.2.
[274] Melzer v CNET Civial Action No. 3021-CC, 8.
[275] Ibid, 4.
[276] Ibid, 10.

inspect documents predating their time.[277] This argument was not accepted by the court. The court reasoned that shareholders might wish to establish demand futility by showing the board's sustained or systematic dereliction of duty to monitor.[278] They could only do that by consulting documents of a considerable time period, including those predating their investments in the company. Thus the shareholders' demand was granted.

Meanwhile, shareholders in the UK have statutory rights to inspect register of members,[279] minutes and resolutions of general meetings in the last ten years,[280] register of charges on the company's assets[281] and directors' service contracts.[282]

3. Securities Litigation

In the US, the SEC's Rule 10b-5 prevents fraud committed with regards to the purchase or sale of transactions.[283] Making false statements in corporate disclosure or omitting material facts is encompassed in this rule. Investors who wish to bring a 10b-5 claim must establish their reliance on the disclosure, causal links between the misstatement and their losses and that the managers knew the statements to be false or were reckless as to their truthfulness.[284] *Basic v Levinson* created a presumption of investors' reliance on the integrity of the market.[285] This presumption is rebutted when the reliance is unreasonable. For example, investors who short sold the company's shares might not be able to rely on this presumption because their short selling indicated that they did not believe in the market price.[286] In *Dura Pharmaceuticals v Broudo*, the Ninth Circuit ruled that the investors suffered losses

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[277] Ibid, 9.
[278] Ibid, 13.
[279] Companies Act 2006, S116.
[280] Ibid, section 744.
[281] Ibid, section 877.
[282] Ibid, section 228.
[283] 17 C.F.R. § 240. 10b-5.
[284] Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005) at 341.
[285] Basic Inc v Levinson 485 U.S. 224 (1988), 241-247.
[286] Frank Partnoy and Randall Thomas, Gap Filling, Hedge Funds and Financial Innovation, Vanderbilt University Law School Law and Economics Working Paper No 06-21, Accessed on May 19, 2019 at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=931254.>, 15.

when they purchased the shares because the price they paid was inflated by the misrepresentation.[287] This ruling was reversed by the Supreme Court, as this approach essentially gave investors insurance against market losses.[288] The court ruled that causation could only be established when the investors' losses were caused by the revelation of the truth, which was concealed or lied about in the disclosure in question.[289]

Securities fraud litigation had attracted much criticism in the US. Most companies have insurance to cover settlements in securities fraud cases. This, combined with disruption and negative publicity associated with litigation, incentivize managers to settle even strong cases.[290] Securities litigation also fails to deter misrepresentation as companies and their managers do not suffer personally from the actions.[291] Meanwhile, securities fraud litigation is mostly commenced as class actions. As plaintiff investors are dispersed, cases are largely controlled by attorneys. Attorneys also have incentives to settle because they would have no payment if the cases are lost. This could result in investors being under-compensated.[292] Managers' willingness to settle also gives attorneys' incentives to bring frivolous suits.[293]

The Private Securities Litigation Reform Act of 1995 sought to address these problems. First, a class action now must have a lead plaintiff, presumably an investor with the largest losses. The hope is that lead plaintiffs could monitor their attorneys.[294] Second, to discourage frivolous suits, the PSLRA prescribes a heightened pleading standard. Plaintiff investors must plead with specificity and create a strong inference that corporate statements were misleading and that the managers knew about or were

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[287] Dura Pharmaceuticals v. Broudo, supra note 284, at 340.
[288] Ibid, 347.
[289] Ibid, 342.
[290] Adam Pritchard, "Market as Monitors: A Proposals to Replace Class Actions with Exchanges as Securities Fraud Enforcers" (1999) 85 Virginia Law Review 925, 953.
[291] John Coffee, "Reforming the Securities Class Action: An Essay on Deterrence and its Implementation" (2006) 106 Columbia Law Review 1534, 1553.
[292] Ibid, 1545.
[293] Ibid, 1546.
[294] Stephen Choi, Pritchard and Jill Fisch, " Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act" (2005) 83 Washington University Law Review 869, 874.

reckless as to the truth.[295] The PSLRA also created a safe harbour for forward-looking statements. As long as projections are accompanied by meaningful cautionary statements, managers are exempted from securities fraud liabilities even when they knew that the projections were misleading.[296]

In the UK, investors who wish to sue against misrepresentations in the company's prospectus are only required to establish loss causation.[297] Investors who wish to sue against misrepresentations in other circumstances must establish their reliance on the disclosure,[298] loss causation and that the managers knew about or were reckless as to the truthfulness of the disclosure.[299] Unlike in the US where reliance is presumed, the reliance element is a significant obstacle to securities fraud litigation in the UK.[300] Group litigation in the UK is similar to class action in the US. But investors must actively join in the group. Compared to the opt-out rule in the US, the opt-in rule reduces the popularity of group litigation in the UK.[301] Securities litigation is rare in the UK.[302] Other than aforementioned obstacles, another explanation for this phenomenon lies in shareholders' stronger voting rights in the UK. As argued by Chiu, shareholders in the US have limited voting rights. Hence they bring securities litigation to achieve ends other than ensuring the quality of corporate disclosure. Meanwhile, shareholders in the UK have more voting rights to achieve these corporate governance ends. Thus their use of securities litigation is mostly limited to corporate disclosure.[303] This results in fewer securities fraud cases in the UK than in the US.

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[295] 15 U.S.C § 78u-4(b)(1)&(2).
[296] Choi *et al*, supra note 294, 874.
[297] Financial Services and Markets Act 2000, section 90.
[298] Ibid, section 90A(5).
[299] Ibid, section 90A(4).
[300] Ellis Ferran, "Are US Style Investor Suits Coming to the UK?" (2009) 9 Journal of Corporate Law Studies 315, 342.
[301] Ibid.
[302] Armour *et al*, supra note 241, 714.
[303] Chiu, supra note 244, 999.

VI. Shareholder Voting Rights

1. Classes of Shares

In both Delaware and the UK, the default rule is that one share carries one vote and one vote only.[304] Companies can opt out of the one-share-one-vote rule by having multiple classes of shares. For example, Facebook has three classes of shares. Class A shares are ordinary shares carrying one vote per share. Class B shares are super voting shares. Each share has ten votes. Class C shares are non-voting shares. Most Class B shares are held by the CEO Zuckerberg, who has 56.9% of the voting rights.[305]

Multiple classes of shares have attracted much controversy. On the one hand, super voting shares give their holders more voting rights than economic interests, which incentivizes self-interested behaviour. Moreover, super voting shares are mostly held by managers. Hence managers can use their super voting rights to oppose shareholder actions, making shareholder activism more difficult and discourage activist shareholders. This exacerbates the agency problem.[306] For example, Masulis *et al* found that companies with greater decoupling of voting rights and economic interests had lower returns from capital expenditure and higher executive remuneration, which suggested that entrenched managers were more likely to engage in empire building.[307] On the other hand, insulating the management from myopic shareholders and market pressure might be beneficial. For example, in 2012, Facebook acquired Instagram. The transaction was viewed negatively by the market

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[304] Companies Act 2006, section 294.
Delaware General Corporation Law § 212.

[305] Victoria Hu, Harikrishna Mehta, Sonal Mittal and Jeffrey Wheeler, Dual-Class Share Structures in Silicon Valley Facebook Inc, Accessed on May 17, 2019 at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2371759&rec=1&srcabs=950295&alg=1&pos=7>, 10.

[306] Lucian Bebchuk, Reinier Kraakman and George Jriantis, Stock Pyramids, Cross-Ownership and Dual Class Equity: Te Creation and Agency Costs of Separating Control from Cash Flow Rights, NBER Working Paper 6951, Accessed on September 15, 2019 at <https://pdfs.semanticscholar.org/d0dd/56615745b65363e5fc4ce134c39a0d40eb80.pdf >, at 11.

[307] Ronald Masulis, Long Wang and Fei Xie, "Agency Problems at Dual-Class Companies" (2009) 64 The Journal of Finance 1697, 1715.

but turned out to be a huge success.[308] If Facebook were wholly exposed to market pressure, the transaction would not have happened. Therefore, regulation of multiple classes of shares requires balancing their benefits and costs.

Up until 1986 the New York Stock Exchange did not allow companies with multiple classes of shares to be listed. But faced with competition from NASDAQ and AMEX which allowed multiple classes of shares, the NYSE dropped the one-share-one-vote rule in 1986.[309] This prompted the SEC to introduce Rule 19c-4, which prohibited all stock exchanges in the US to list companies with multiple classes of shares.[310] The rule was shortly struck down by the DC Circuit because the SEC did not have rule-making power on non-disclosure related issues.[311] Eventually a compromise was reached. Companies can go public with multiple classes of shares, but cannot create new classes by reducing the voting rights of existing shares.[312] This is because shareholders' collective action problem is likely to prevent them from vetoing the purchase of their voting rights at unfair price.[313]

In the UK, companies with Premium Listings cannot have multiple classes of shares.[314] Many commentators argued that this restrictive approach has reduced the LSE's listings.[315] Indeed, prohibiting IPOs of companies with multiple classes of shares is unnecessary because investors are free to not invest in companies whose share structures create serious agency problems. For example, when Snap went public in 2017, all the publicly offered shares were non-voting shares. Many institutional investors refuse to buy the shares.[316] The Council of Institutional Investors even successfully lobbied to have Snap be removed from major indexes, including MSCI,

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[308] Kashmir Hill, 10 Reasons Why Facebook Bought Instagram, Forbes (April 11, 2012).

[309] Bernard Sharfman, "A Private Ordering Defense of a Company's Right to Use Dual Class Share Structures in IPOs" (2018) 63 Villanova Law Review 1, 7.

[310] Business Roundtable v Securities and Exchange Comission 905 F.2d 406 (1990) 407.

[311] Ibid, 410.

[312] NYSE Listed Company Manual § 313.00; NASDAQ Stock Market Rules, Rule 5640.

[313] Ronald Gilson, "Evaluating Dual Class Common Stock: The Relevance of Substitutes" (1987) 73 Virginia Law Review 807, 822.

[314] FCA, PS 14/8: Response to CP 13/15-Enhancing the Effectiveness of the Listing Regime, Accessed on May 17, 2019 at < https://www.fca.org.uk/publication/policy/ps14-08.pdf> at 5.22.

[315] Henry Angest, In Defence of Dual-Class Shares with Different Rights, Financial Times (April 16, 2019).

[316] Stephen Foley and Hannah Kuchler, Snap's Offer of Voteless Shares Angers Big Investors, Financial Times (February 3, 2017).

S&P 500 and FTSE Russell.[317]

2. Appointment and Removal of Directors

Most companies with dispersed shareholders adopt proxy voting systems. The board sends shareholders proxy cards in which it lists the issues to be voted on in general meeting and asks to be appointed as shareholders' proxies.[318] Shareholders grant proxies to the board by signing the proxy cards and returning them to the company. Shareholders also mark the proxy cards to instruct the board on how to vote on the proposals. In the general meeting, the board will vote according to shareholders' instructions and there is no need for shareholders to attend the meeting in person. In a proxy fight, dissident shareholders prepare their own proxy cards, in which they list their director nominees. The proxy cards are printed and distributed to other shareholders at the dissidents' own costs. Other shareholders vote by choosing whether to grant proxies to the dissidents or to the board. Proxy fights are extremely expensive. Although both the US and the UK allow for electronic proxy cards,[319] other costs, such as hiring proxy solicitors and campaigning for votes, remain significant. Gantchev estimated that average cost of proxy fights is $10.71 million.[320]

Shareholders in Delaware face two difficulties when they seek to appoint or remove directors. First, the default rule is the plurality rule.[321] Under the plurality rule, the director having the most votes is elected, regardless of how many votes are withheld or casted against her. In an uncontested election, where the number of board vacancies and director nominees are the same, the plurality rule makes it impossible to vote down directors, discouraging shareholders from voting at all. In 1993, Grundfest launched a Just Vote Campaign, urging shareholders to vote no even when doing so would not change the outcome of the votes. The hope is that high

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[317] Trevor Hunnicutt, S&P 500 to Exclude Snap after Voting Rights Debate, Reuters (August 1, 2017)
[318] 17 C.F.R. § 240.14a-2; Companies Act 2006, section 324.
[319] SEC Rule on Shareholder Choice regarding Proxy Material, RIN 3235-AJ79.
Companies Act 2006, section 333.
[320] Nickolay Gantchev, "The Costs of Shareholder Activism: Evidence from a Sequential Decision Model" (2013) 107 Journal of Financial Economics 610, 611.
[321] Delaware General Corporation Law § 216(3).

disapproval votes would shame the board into improvement.[322] Empirical studies did find more CEO turnovers and improved corporate performance after the campaigns.[323] In many companies shareholders succeeded to replace the plurality rule with the majority rule, under which only directors receiving a majority of votes can be elected. For example, Kahan and Rock found that in 2004, only 10 of the S&P 500 companies did not adopt the plurality rule. In 2007, 81 companies had majority voting.[324] Delaware also responded by preventing boards from repealing bylaws adopted by shareholders introducing the majority rule.[325] The problem with the majority rule is that given shareholder passivity, it might result in no director being elected. In that case, a second election must be held, increasing corporate costs.[326] But this problem is mitigated with the rise of institutional shareholders.

Second, although the default rule in Delaware is that shareholders can remove directors by a simple majority without cause,[327] companies can opt out of this rule by having staggered boards. Delaware allows companies to have up to three classes of directors.[328] Each year only one group of directors are up for election. Hence changing control of the board would take two years. The costs of two proxy fights significantly discourage shareholders from changing board control. But shareholders have managed to destagger boards in many companies. For example, Kahan and Rock found that in 2003, 44% of S&P 100 companies had staggered boards. In 2009, only 16% companies had staggered boards.[329]

In 2010, the SEC introduced Schedule 14a-11, a mandatory proxy access rule which allowed shareholders holding three percent of the company's shares for three years to nominate directors on the company's proxy card.[330] The rule was quashed by

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[322] Joseph Grundfest, "Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates" (1993) 45 Stanford Law Review 857, 906.
[323] Diane Del Guercio, Laura Seery and Tracie Woidtke, "Do Boards Pay Attention When Institutional Investor Activists Just Vote No" (2008) 90 Journal of Financial Economics 84, 85.
[324] Marcel Kahan and Edward Rock, "Embattled CEOs" (2010) 88 Texas Law Review 987, 1010.
[325] Delaware General Corporation Law § 216(4).
[326] J Verret, "Pandora's Ballot Box or a Proxy with Motive? Majority Voting, Corporate Ballot Access and the Legend of Martin Lipton Re-Examined" (2007) 62 Business Lawyer 1007.
[327] Delaware General Corporation Law § 141(k).
[328] Ibid, § 141(d).
[329] Kahan and Rock, supra note 324, 1009.
[330] Business Roundtable v SEC, 647 F.3d 1144 (DC Cir. 2011) at 1147.

the DC Circuit. The court ruled that the SEC acted arbitrarily and capriciously by ignoring economic consequences of the rule, one of which is that the board might spend significant corporate resources to fight shareholders' nominees.[331] Another negative consequence of the rule is the possibility of self-interested activism engaged by union and public pension funds.[332] Empirical studies indeed found that the market reacted negatively to events increasing the probabilities of the rule's adoption.[333] After the court's ruling, the SEC changed the proxy access rule into an opt-in default rule.[334]

In the UK, the majority rule is the default rule for the election of directors.[335] Shareholders also have a statutory right to remove directors by ordinary resolution.[336] As shareholders holding 5% of the company's shares can call general meetings,[337] staggered boards do not work in the UK.

3. Shareholder Proposals

(1)US

In Delaware, company law leaves corporate charters and bylaws to decide whether shareholders can submit proposals and how many votes are needed to pass their proposals. Meanwhile, the SEC's Rule 14a-8 allows qualifying shareholders to add proposals of proper subjects to the company's proxy card.[338]

Qualifying shareholders are shareholders holding shares of at least 1% of the company's outstanding shares or worth $2,000, whichever is the less, for more than a

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[331] Ibid, 1149.
[332] Ibid, 1152.
[333] Ali Akyol, Weifen Lin and Patrick Verwijmeren, "Shareholders in the Boardroom: Wealth Effects of the SEC's Proposal to Facilitate Director Nominations" (2012) 47 Journal of Financial and Quantitative Analysis 1029, 1030.
[334] Delaware General Corporation Law § 112.
[335] Model Articles for Public Companies, Article 20.
[336] Companies Act 2006, section 168.
[337] Ibid, section 303.
[338] 17 C.F.R. § 240.14a-8.

year.[339] The SEC listed thirteen types of improper subjects.[340] Notably, shareholders cannot submit proposals on the company's ordinary business, as it is the management's prerogative.[341] But shareholders are also prohibited from submitting proposals on general issues. Their proposals must be related to at least 5% of the company's revenues or assets. Thus shareholder proposals must be specific, but not too specific to interfere with the company's routine business. This limits the subjects of shareholder proposals to fundamental corporate issues. But not all fundamental issues are proper subjects for shareholder proposals. For example, shareholders cannot nominate directors in their proposals. The rationale is that director election is such an important issue that the information shareholders need to make this decision cannot be fully provided in shareholder proposals with a maximum of 500 words.[342] Shareholder proposals must be submitted to the company 120 days before the proxy mailing date.[343] Hence a company can avoid an anticipated proposal by moving ahead the general meeting. Shareholder proposals are passed by simple majorities and are not binding on the company.

Although the shareholder proposal rule is limited in scope, it has significant effect as it transfers the cost of circulating shareholder proposals from shareholders to the company. The rule has attracted much controversy. Critics argue that in enacting the rule, the SEC exceeded its regulatory authority. Pursuant to Section 14 of the Securities Exchange Act of 1934, the SEC is given power to regulate proxy solicitation with the objective of promoting fair corporate suffrage. In the critics' view, the SEC's power is confined to making disclosure rules. Rule 14a-8 interferes with the allocation of corporate assets, which is a company law issue and is thus *ultra vires*.[344]

Supporters of the rule reviewed the legislative history of Section 14. Based on records of Congressional debates, they found that Congress was aware of the potential conflicts between company law and securities law. The final version of the section

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[339] Ibid.
[340] Ibid.
[341] 17 C.F.R. § 240. 14a-8(7).
[342] 17 C.F.R. §240. 14a-8(8).
[343] 17 C.F.R. § 240. 14a-8(b)(2)(ii)(C)(e).
[344] George Dent, "Proxy Regulation in Search of a Purpose: A Reply to Professor Ryan" (1989) 23 Georgia Law Review 815, 816.

showed Congress's willingness to allow the SEC to intrude to some extent into company law in order to achieve fair corporate suffrage.[345] Advocates also tried to justify the rule from a pure disclosure perspective. They argued that shareholder proposals reveal shareholders' view, which is important information to other shareholders. Shareholder proposals also propel management to reveal more information in response.[346] However, more disclosure is not always better. A large amount of irrelevant information would discourage shareholders from reading proxy cards, which is why disclosure rules are only concerned with material information.[347] Hence whether this argument is valid depends on whether shareholders value information contained in shareholder proposals.

The shareholder proposal rule was introduced in 1942. In the first 40 years of its history, most shareholder proposals were brought by social activists on issues of corporate social responsibility. Support rate for these proposals were usually below 5%.[348] This showed that most shareholders did not believe shareholder proposals were of value. The 1980s witnessed a sharp increase in hostile takeovers and companies' wide adoption of anti-takeover devices. Public pension funds reacted by submitting shareholder proposals to dismantle takeover defences. Support for these proposals typically ranged from 20% to 40% of the votes. Some proposals succeeded to remove takeover defences.[349] After the takeover decade, public pension funds continue to submit shareholder proposals to address corporate governance issues. Shareholder proposals have also become powerful weapons of hedge funds. Thus the shareholder proposal rule is increasingly justified in practice.

(2)UK

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[345] Patrick Ryan, "Rule 14a-8, Institutional Shareholder Proposals and Corporate Democracy" (1988) 23 Georgia Law Review 97, 134.
[346] Susan Liebeler, "A Proposal to Rescind the Shareholder Proposal Rule" (1984) 18 Georgia Law Review 426, 444.
[347] Dent, supra note 344, 821.
[348] George Dent, "SEC Rule 14a-8: A Study in Regulatory Failure" (1985) 30 New York Law School Law Review 1, 5.
[349] Ryan, supra note 345, 160.

In the UK, shareholders holding 5% of the company's shares can request the board to call general meetings.[350] The board must call a general meeting within 21 days of receiving the request[351] and the meeting must be held within 28 days of sending the notice.[352] The shareholders can call general meetings at the company's expense if the board fails to act on their request.[353]

Shareholders holding 5% of the company's voting rights can request the board to circulate statements of no more than 1,000 words to shareholders concerning issues to be dealt with in general meetings.[354] The expenses are borne by the company if the meetings to which the statements relate are annual general meetings and the requests are made sufficiently before the end of the financial year.[355] The default rule is that shareholders must pay for the circulation of statements in other occasions, but the company can opt out of this rule.[356]

Shareholders holding 5% of the company's voting rights can request the company to circulate their resolutions and statements of no more than 1,000 words.[357] The default rule is that the expenses are borne by the shareholders.[358] There is no restriction on the content of the resolutions, except that they could not be frivolous or contradict with the company's articles.[359] In *Automatic Self-Cleansing Filter Syndicate Company Limited v Cuninghame*, a simple majority of shareholders passed a resolution to direct the board to sell the company's assets.[360] The court invalidated the resolution because the company's articles provided that the board had managerial power. As a supermajority was required to amend the articles,[361] allowing a simple majority to direct the board which had the same effect as amendment of articles would

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[350] Companies Act 2006, section 303.
[351] Ibid, section 304(1)(a).
[352] Ibid, section 304(1)(b).
[353] Ibid, section 305.
[354] Ibid, section 314.
[355] Ibid, section 316 (1).
[356] Ibid, section 316(2).
[357] Ibid, section 292.
[358] Ibid, section 294.
[359] Ibid, section 292(2).
[360] Automatic Self-Cleansing Filter Syndicate Company Limited v Cunninghame [1906] 2 Ch 34, 37.
[361] Ibid, 38.

undermine the company's articles of association.[362] But the resolution could have been valid if it were passed by a supermajority. The default rule in the UK is that shareholder resolutions are passed by supermajorities. They can direct the board to act, but not to invalidate actions already taken.[363] As removing directors takes only a simple majority, shareholder resolutions are less frequently used in the UK than in the US.[364]

4. Approval and Veto Power

Shareholders can engage in activism by withholding votes on fundamental corporate issues. In Delaware, mergers[365] and dissolution of the company must be approved by shareholders holding a majority of the company's voting rights.[366] Shareholder approval is also needed when the company sells all of its assets.[367] Companies' charters authorize the number of shares boards can issue. Share issuance exceeding this amount requires shareholder approval.[368] In Delaware, amendment of certificate of incorporation can only be initiated by the board, which needs to be approved by a majority of the shares.[369] Shareholders are able to initiate bylaw amendments.[370] What matters are proper for shareholder-adopted bylaws used to be unclear. Section 109 gives shareholders power to adopt, amend and repeal bylaws provided that doing so is consistent with the certificate of incorporation and the law. Meanwhile, Section 141 gives the board power to manage the company, subjecting to limitations in the certificate and the law, which could include Section 109. As noted by Gordon, there is a recursive loop between the two sections.[371] The issue was

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[362] Ibid.

[363] Model Articles for Public Companies, Article 9.2.

[364] Bonnie Buchanan, Jeffry Netter, Annette Poulsen and Tina Yang, "Shareholder Proposal Rules and Practice: Evidence from a Comparison of the United States and United Kingdom" (2012) 49 American Business Law Journal 739, 743.

[365] Delaware General Corporation Law § 251(c).

[366] Ibid, § 275.

[367] Ibid, § 271.

[368] Ibid, § 161.

[369] Ibid, § 242.

[370] Ibid, § 109(a).

[371] Jeffrey Gordon, "Just Say Never?: Poison Pills, Deadhand Pills and Shareholder-Adopted Bylaws:

settled in *CA Inc v AFSCME Employees Pension Plan*.[372] AFSCME proposed a bylaw which would require the company, CA, to reimburse shareholders for nominating directors if one or more nominees are elected.[373] The Supreme Court of Delaware stated that the bylaw would prevent directors from fully exercising their managerial power and cause them to breach their duties to the company.[374] Thus the court settled the recursive loop problem by ruling that Section 141 prevails over Section 109. Afterwards shareholder-adopted bylaws are mostly limited to procedural issue.[375] Meanwhile, the board is free to repeal shareholder-adopted bylaws and to introduce bylaws which impede shareholder activism. For example, in *ATP Tour Inc. v Deutscher Tennis Bund*,[376] the Supreme Court of Delaware upheld a board-adopted bylaw which requires the losing party in intra-corporate litigation to pay for the winning party's legal expenses. To readdress the balance of power between shareholders and the board, Delaware Company Law bans fee-shifting bylaws.[377] It also prohibits the board from repealing shareholder-adopted bylaws to implement the majority rule, the proxy access rule[378] and to reimburse activist shareholders.[379]

The Dodd-Frank Act was enacted in response to the subprime mortgage crisis. Section 951 gives the SEC power to require disclosure on executive remuneration. Accordingly the SEC introduced a say-on-pay regime. Companies must disclose compensation received by the CEO, CFO and three other most highly paid executive officers.[380] Shareholders can choose to cast advisory votes on executive compensation every year, every other year or every three years.[381] Abstaining or voting against executive remuneration has been one of the most powerful weapons of

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An Essay for Warren Buffet" (1997) 19 Cardozo Law Review 511, 546

[372] CA Inc v AFSCME Employees Pension Plan 953 A.2d 227 (Del. 2008).

[373] Ibid, 230.

[374] Ibid, 239

[375] John Coffee, "The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests" (1997) 51 University of Miami Law Review 605, 614.

[376] ATP Tour Inc. v Deutscher Tennis Bund (C.A.No. 07-178)

[377] Delaware General Corporation Law § 102(f).

[378] Ibid, § 112.

[379] Ibid, § 113.

[380] SEC Rule on Shareholder Approval of Executive Compensation and Golden Parachute Compensation, RIN 3235-AK68.

[381] Ibid.

activist shareholders.

In the UK, merger[382] and division of the company[383] must be approved by special resolutions. Special resolutions are also required for reduction of capital[384] and share buybacks.[385] Companies' articles authorize the number of shares boards can issue.[386] The default rule is that shareholders have preemptive rights to purchase newly issued shares proportionate to their shareholdings. Preemptive rights do not apply to non-cash issuance or shares which are issued as compensation for managers and employees.[387] Preemptive rights protect existing shareholders from being diluted by newly issued shares. But requiring existing shareholders to subscribe first slows down new issuance while market conditions can shift quickly.[388] Thus in normal circumstances, shareholders waive preemptive rights by special resolutions. But most shareholders insist on their preemptive rights when the new issuance accounts for more than 10% of the company's outstanding shares.[389] Refusing to subscribe to newly issued shares can be a shareholder activism technique. As it sends a negative signal to public investors which could make new issuance unsuccessful, mangers might be pressurized to accommodate shareholders' demands. But shareholders who refuse to exercise their preemptive rights could also end up with diluted positions.[390] Shareholders holding more than 5% of shares can initiate amendments to articles which are passed by special resolutions.[391] Listed companies must have shareholder approval to carry out class 1 transactions (transactions exceeding 25% of the company's assets, profits or capital).[392] The UK has an advisory say-on-pay regime since 2002. The regime was enhanced after the subprime mortgage crisis. Currently shareholders have binding votes every three years on directors' remuneration

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[382] Companies Act 2006, section 907.
[383] Ibid, section 922.
[384] Ibid, section 641.
[385] Ibid, section 659.
[386] Ibid, section 551.
[387] Model Articles for Public Companies, Article 6.30(b)(3).
[388] Marco Ventoruzzo, "Issuing New Shares and Preemptive Rights: A Comparative Analysis" (2013) 12 Richmond Journal of Global Law and Business 517, 518.
[389] Bernard Black and John Coffee, "Hail Britannia? Institutional Investor Behavior Under Limited Regulation" (1994) 92 Michigan Law Review 1994, 2035.
[390] Ibid, 2036.
[391] Companies Act 2006, section 21.
[392] FCA Handbook, Listing Rules 10.5.1.

policies[393] and advisory votes every year on directors' remuneration report.[394]

To summarize, in the UK companies with premium listings cannot have multiple classes of shares. Shareholders have statutory rights to call general meetings, to remove directors and to amend articles of association. The majority rule for the election of directors and preemptive rights are opt-out default rules. These all make shareholders in the UK more powerful than shareholders in Delaware.

VII. Conclusion

This chapter introduced how shareholders can engage in activism by examining the division of power between the board and shareholders. It found that in the UK directors have more stringent duties and shareholders have stronger voting rights than their counterparts in Delaware. This raises several questions, namely, why corporate power is divided in these ways, why the division is different in Delaware and the UK and how this difference affects shareholder activism. This chapter has already showed how different levels of shareholder power affect shareholders' preference in activism techniques. Chapter 5 will further demonstrate this point. Chapter 3 seeks to answer the first two questions by examining the theoretical framework underpinning the legal regime.

[393] Companies Act 2006, section 439A.
[394] Ibid, section 439.

Chapter 3 Theoretical Framework of Institutional Shareholder Activism

The previous chapter introduced how shareholders can engage in activism by examining and comparing the division of power between shareholders and the board in the US and the UK. It raised the question why corporate power is divided in such ways or what is the optimal level of shareholder power. Another main issue in corporate governance is to what end should the company be managed. How these questions are answered determine one's view on the desirability of shareholder activism. To answer these questions, this chapter establishes a theoretical framework of the company by reviewing main theories on the subject. It argues that the optimal level of shareholder power should minimize agency costs at the lowest costs to the company. It then examines the limits of the benefits of shareholder activism, or the exercise of shareholder power, by studying the effectiveness of other corporate governance mechanisms to control agency costs.

The chapter is organized as follows. Section I studies the concession theory and the managerialist theory. Section II presents an overview of the contractarian theory. Section III introduces the effectiveness of other corporate governance mechanisms, namely board monitoring, incentive alignment and market discipline. Section IV concludes.

I. The Concession Theory and the Managerialist Theory

At the beginning of corporate law history, firms could only be incorporated by special charters. In the UK, incorporation charters were originally issued by the Crown. The power was later shared by Parliament.[1] In the US incorporation charters were granted by State governments.[2] Incorporation charters were granted sparingly in the UK. Hence most firms were organized as joint stock companies instead, which were partnerships with transferrable shares and law of business organizations in the

[1] Phillip Blumberg, "Limited Liability and Corporate Groups" (1986) 11 Journal of Corporation Law 573, 581.
[2] Ibid, 587.

UK was largely developed on partnership principles.[3] As a result, managerial power of the board is considered a negotiated outcome between the board and shareholders and shareholders are allowed to renegotiate by initiating charter amendments.[4] In contrast, incorporation charters were granted much more generously in the US and most firms were incorporated. Board power is consequently considered a product of the law, which shareholders have no right to intervene.[5]

At the time incorporation charters and corporate legal personality were considered sovereign gifts[6], which the state used to encourage the setting up of organizations which were beneficial to the society. This explained why most charters were granted to banks, universities, hospitals and charities.[7] As companies were regarded as extensions of the government, state intervention of corporate affairs to achieve state goals was perfectly justified.[8] This theory was later termed the concession theory.[9]

The concession theory lost most of its strength after the introduction of incorporation by registration. In the UK incorporation by registration was allowed by the Joint Stock Company Act 1844. States in the US also converged to incorporation by registration in the late nineteenth century.[10] However, even though incorporation no longer requires state charter, companies still only exist because the law recognizes this organizational form. This still justifies state intervention to some extent.

The UK introduced limited liability in the Limited Liability Act 1855, while States in the US experimented with different shareholder liability rules. New York implemented limited liability in as early as 1811 whereas California had a pro rata

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[3] Paddy Ireland, "Limited Liability, Shareholder Rights and the Problem of Corporate Irresponsibility" (2010) 34 Cambridge Journal of Economics 837, 840.
[4] Companies Act 2006, Section 21.
David Kershaw, Hostile Takeovers and the Non-Frustration Rule: Time for a Reevaluation, LSE Law, Society and Economy Working Papers 19/2016, Accessed on April 17, 2019 at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2875772&download=yes>, 12.
[5] Delaware General Corporation Law § 242.
Kershaw, ibid, 13.
[6] Joshua Barkan, *Corporate Sovereignty: Law and Government under Capitalism* (University of Minnesota Press, 2013), 20.
[7] Ibid, 32.
[8] Ibid.
[9] Martin Petrin, "Reconceptualizing the Theory of the Firm: From Nature to Function" (2013) 118 Pennsylvania State Law Review 1, 9.
[10] Blumberg, supra note 1, 587.

rule until 1931.[11] All states converged to limited liability in the 1930s.[12] With limited liability, shareholders are only liable for the unpaid nominal value of their shares upon the company's insolvency. As shareholders are no longer jointly and severally liable for the company's debts, they no longer need to monitor the wealth of other shareholders.[13] Shareholders can also choose not to monitor the management. Thus limited liability allows small investors who are unable to monitor to participate in the capital market, gives companies large pools of capital and results in some extremely large companies.[14] Berle and Means observed in 1932 that the 200 largest companies in the US collectively controlled one-third of the nation's wealth.[15] These large companies wielded considerable power, both internally on their shareholders and employees who made up a large proportion of the population and externally, shaping their industries and the society at large. Two issues were raised by this phenomenon: how to make corporate power accountable and to what end should corporate power be exercised.

As argued in Chapter 1, in the US and the UK where share ownership is dispersed, corporate control rests with managers. The board, which should monitor managers, was captured by managers as they controlled directors' nomination and remuneration.[16] Markets at the time were also unable to make managerial power accountable. Often share prices did not reflect corporate value and companies only paid attention to their share prices when they needed to issue new shares.[17] But share issuance was rare. Many companies held monopolistic positions in their markets, which not only weakened the discipline of the product market, but also enabled them

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[11] Shareholders' liabilities for the company's debts are pro rata to their shareholdings. Blumberg, ibid, 598.

[12] Ibid.

[13] Henry Hansmann and Reinier Kraakman, "Toward Unlimited Shareholder Liability for Corporate Torts" (1991) 100 The Yale Law Journal 1879, 1906.

[14] Frank Easterbrook and Daniel Fischel, "Limited Liability and the Corporation" (1985) 52 The University of Chicago Law Review 89, 97.

[15] Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (10th edn, Transaction Publishers, 2009), 9.

[16] Martin Gelter, The Pension System and the Rise of Shareholder Primacy, Fordham University School of Law Legal Studies Research Paper No. 2079607, Accessed on August 22, 2019 at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2079607>, 5.

[17] Marc Moore and Antoine Reberioux, "Corporate Power in the Public Eye: Reassessing the Implications of Berle's Public Consensus Theory" (2010) 32 Seattle University Law Review 1109, 1121.

to secure most of the capital they needed from consumers.[18] Berle's solution to the managerial accountability problem was twofold. Because of their considerable social impact, Berle considered companies public entities which should be accountable to the public. The public should sanction companies which were managed against public consensus, such as by boycotting their products. The state should intervene when the public fails to act or when companies do not respond to public pressure.[19] The possibility of sanctioning by the public and the state should encourage managers to exercise corporate control responsibly.[20]

In the 1930s, Berle and Dodd had a famous debate on what should be the company's objective. Dodd argued that other than making profits for their shareholders, companies should also promote the public interest[21] while Berle advocated for a pure shareholder interests approach.[22] But Berle and Dodd actually agreed on more things than it appeared. Both Berle and Dodd considered companies public entities which should be managed in the public interest. They only differed on their views on managerial accountability. Dodd believed that managers who were able to rise to their positions had the sense of responsibility to manage the company in the public interest.[23] Berle, on the other hand, believed that managers who were free to decide how to promote the public interest would only pursue their private benefits. Limiting the company's objective to shareholder interests would make managerial power more accountable.[24] At the time half of America's population held corporate shares. Berle believed this number to be higher in the future[25] and considered shareholder value a means to promote the public interest.[26] In fact, Berle never

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[18] Adolf Berle, "Property, Production and Revolution: A Preface to the Revised Edition" in Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (10th edn, Transaction Publishers, 2009), xxvii.
[19] Moore and Reberioux, supra note 17, 1126.
[20] Ibid.
[21] Edwin Merrick Dodd, "For Who Are Corporate Managers Trustees" (1932) 45 Harvard Law Review 1145, 1148.
[22] Adolf Berle, "For Whom Corporate Managers Are Trustees: A Note" (1932) 45 Harvard Law Review 1365, 1372.
[23] Dodd, supra note 21, 1148.
[24] Berle, supra note 22, 1367.
[25] Berle, supra note 18, xxxii.
[26] Dalia Tsuk Mitchell, "From Pluralism to Individualism: Berle and Means and 20th Century American Legal Thought" (2005) 30 Law and Society Inquiry 179, 208.

viewed shareholder value as an end itself. According to Berle, shareholders neither provided capital nor participated in the operation of the company. The only justification for them sharing the company's profits was that it distributed wealth to the public.[27] Thus shareholder value promoted by Berle was different from shareholder value in the contractarian theory, which was an end itself.[28] Based on their views on managers Dodd was characterized as pro-managerialist while Berle was characterized as anti-managerialist.[29] Dodd later conceded that managers might exercise corporate control to pursue private benefits. But he believed that directors' duties and the markets could effectively ensure managerial accountability. Thus his position moved closer to the contractarian theory.[30]

The managerialist theory has become largely outdated. After its formulation, anti-trust law was introduced, breaking up monopolies and subjecting companies to more competitive pressure.[31] Securities law enhanced corporate disclosure which moved companies' share price closer to their fundamental value, enhancing market discipline.[32] Increased transparency also fueled an increase in hostile takeovers.[33] In the UK the market for corporate control has been active since the 1960s.[34] In the 1980s the US experienced so dramatic a wave of hostile takeovers that the 1980s were later termed the takeover decade.[35] Afterwards it could no longer be said that companies do not care about their share price. The corporate governance movement in the US and the UK introduced independent directors who improved board monitoring.[36] The rise of institutional investors also made shareholder activism a potential corporate governance mechanism. The managerialist theory advocated for public and state intervention because there was no effective mechanism to ensure

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[27] Berle, supra note 18, xxv.
[28] See Section II.
[29] William Bratton and Michael Watcher, "Shareholder Primacy's Corporatist Origins: Adolf Berle and the Modern Corporation" (2008) 34 The Journal of Corporation Law 100, 135.
[30] Ibid, 133.
[31] Mitchell, supra note 26, 215.
[32] Ibid.
[33] See Section III.
[34] John Armour and David Skeel, "Who Writes the Rules for Hostile Takeovers and Why? The Peculiar Divergence of US and UK Takeover Regulation" (2007) 95 The Georgetown Journal 1727, 1755.
[35] Ibid, 1768.
[36] See Section III.

managerial accountability. The developments in corporate governance have made it much less justified.

II. The Contractarian Theory

1. Nexus of Contracts

The contractarian theory responded to the aforementioned changes in law and the markets. Formed in the 1970s, it considers the company as a nexus, through which investors, managers and employees contract with each other.[37] As there are explicit contracts between the company and other stakeholders, the contractarian theory is challenged mainly on whether the relationships between the company and its shareholders are contractual. First of all, the notion of contract adopted by the contractarian theory is looser than its legal sense. Contracts in the economic sense are voluntary agreements of exchange. This notion emphasizes consent and plays down legal elements such as consideration.[38] For there to be economic contracts between the company and its shareholders, shareholders must sufficiently understand contractual terms and have bargaining power over the terms.

A company's articles of association outline the power of directors and shareholders and serve as key contractual terms.[39] Other information, such as the company's risk factors and capital structure might also be important to contracting. In the US, company law rules are considered contractual terms, because incorporation competition gives companies different sets of rules to choose from.[40] As there is no incorporation competition in the UK, company law serves more like background rules to contracting, rather than contractual terms.[41]

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[37] Michael Jensen and William Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 Journal of Financial Economics 305, 310

[38]Ross Grantham, "The Doctrinal Basis of the Rights of Company Shareholders" (1998) 57 The Cambridge Law Journal 554, 580

[39]The Companies Act 2006, Section 33(1)

[40]Frank Easterbrook and Daniel Fishel, "The Corporate Contract" (1989) 89 Columbia Law Review 1416, 1430

[41] Marc Moore, "Private Ordering and Public Policy: The Paradoxical Foundations of Corporate

Brudney argued that most shareholders do not read the company's articles or do research on the company before investing.[42] The contractarian theory considers this fact irrelevant because in a strongly efficient market, all information is reflected in the company's share price, which shareholders understand fully.[43] As will be argued later, the market is not strongly efficient, but it is efficient enough to give shareholders sufficient information on the company before they invest.[44] Thus contractual terms are sufficiently understood by shareholders. Brudney also argued that most shareholders are unable to negotiate with the company over contractual terms.[45] However, the market offers thousands of companies available for investment. Investors who are unsatisfied with one company's contractual terms can invest in another company. This wide range of choices renders actual negotiation unnecessary.[46] Hence shareholders do have bargaining power and their relationships with the company are indeed contractual.

The next question raised by the contractarian theory is that since the company is a nexus of contracts, how is it different from the market. To some contractarians, the company is not different from the market. As it is inconvenient to list the names of all constituencies each time a contract is made, a nexus or a company is formed to facilitate contracting. Hence to these contractarians incorporation is a mere matter of convenience[47] or a fiction[48] of only procedural significance. This argument might hold if listing all parties in contracts were the only limit of contracting, or of the market. But transacting in the market has other limitations and incorporation is a response to these problems. One of the main problems is the problem of incomplete contracts.

Coase observed that transacting in the market by contracting has costs, such as

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Contractarianism" (2014) 34 Oxford Journal of Legal Studies 693, 709

[42]Victor Brudney, "Corporate Governance, Agency Costs and the Rhetoric of Contract" (1985) 85 Columbia Law Review 1403, 1411

[43]Easterbrook and Fishel, supra note 40, 1430

[44]Section III.

[45] Brudney, supra note 42, 1412.

[46] Easterbrook and Fishel, supra note 40, 1430.

[47] Ibid, 1426.

[48] Jensen and Meckling, supra note 37, 310.

the costs of negotiation.[49] High transaction costs might force transacting parties to leave contracts incomplete. Bounded rationality is another cause of incomplete contracts.[50] Orthodox economics assumes that economic actors are rational, have full information and always act to maximize their utility.[51] In the assumptions of orthodox economics, economic actors make decisions by choosing from a set of options the one which best promotes their desired outcomes.[52] But real actors often have difficulties knowing what are in their best interests or how to achieve the desired results. Hence real actors do not always act to maximize their utility. In contracting, bounded rationality means that contracts might not correctly or fully reflect the intentions of contracting parties.[53] Contracting parties are also unlikely to foresee all future events, leaving contracts incomplete.[54] This problem will be exacerbated if contracting parties do not have sufficient information.

Incomplete contracts give rise to the opportunism problem. Generally there are two types of opportunistic behaviour. A contracting party who has made a transaction-specific investment is subject to the problem of holdup.[55] Take the case of a manufacturer who has bought special machinery in order to produce products which are only needed by one buyer. If, after the manufacturer's purchase, a contingency arises which incentivizes the buyer to pay a lower price for the products, the manufacturer has no choice but to tolerate the exploitation because her losses from terminating the contract and losing her transaction-specific investment would be higher than her losses from the buyer's exploitation. The holdup problem also exists the other way around. Suppose the buyer, in order to encourage the manufacturer to make the transaction-specific investment, contracts to buy the manufacturer's

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[49] Ronald Coase, "The Nature of the Firm" (1937) 4 Economica 386, 390.
[50] Herbert Simon, "Bounded Rationality" in John Eatwell, Murray Milgate and Peter Newman P. (eds) *Utility and Probability* (The New Palgrave, 1990), 15.
[51] Jules Coleman, "Efficiency, Exchange and Auction: Philosophic Aspects of the Economic Approach to Law" (1980) 68 California Law Review 221, 223.
[52] Herbert Simon, "Theories of Decision-Making in Economics and Behavioral Science" (1959) 49 The American Economic Review 253, 256.
[53] Ibid, 267.
[54] Iain Macneil, "Company Law Rules: An Assessment from the Perspective of Incomplete Contract Theory' (2001) Journal of Corporate Law Studies 107, 113.
[55]Armen Alchian and Susan Woodword, "The Firm is Dead; Long Live the Firm: A Review of Oliver E. Williamson's The Economic Institutions of Capitalism" (1988) 26 Journal of Economic Literature 65, 67.

products at a fixed price. If a contingency arises which motivates the manufacturer to decrease the quality of the products, the buyer would be subject to the problem of holdup.[56]

Another opportunism problem is the problem of moral hazard.[57] Suppose one individual is hired to perform a task, but the desired outcome cannot be specified in contract, either because the other party is not certain what the final product should be or because the quality of the final product would be difficult to assess.[58] This gives the individual an incentive to shirk,[59] or not act as diligently as she should. It also incentivizes the individual to pursue private benefits, an action commonly referred to as rent-seeking.[60] The moral hazard problem also arises when individuals work in teams and the final products are inseparable. Since each member's contribution cannot be measured, all members have incentives to shirk or to seek rents. This problem is sometimes termed as the team production problem.[61]

Both transaction-specific investments and team production are beneficial to business. But market actors would be discouraged from these activities if the problem of incomplete contracts is not effectively addressed. Several approaches have been developed to address this problem. Coase proposed that an alternative to contracting is integration. With a hierarchy in the firm, those on the upper layers of the hierarchy can simply direct those on the lower layers to act.[62] But Coase did not address more specific issues with integration, such as who should have control.

The property right theory was formed by Grossman, Hart and Moore. It argued that independent actors are vulnerable to the opportunism of all other contracting parties. This could be mitigated by integration, where other members forego their

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[56] Ronald Gilson and Mark Roe, "Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization" (1993) 102 The Yale Law Journal 871, 889.
[57] Alchian and Woodword, supra note 55, 68.
[58] Philippe Aghion and Jean Tirole, "The Management of Innovation" (1994) 109 The Quarterly Journal of Economics 1185, 1186.
[59] Eric Orts, "Shirking and Sharking: A Legal Theory of the Firm" (1998) 16 Yale Law and Policy Review 265, 279.
[60] Joseph Stiglitz, Discouraging Rivals: Managerial Rent Seeking and Economic Insufficiencies, NBER Working Paper No 4145, Accessed on April 19, 2019 at <https://www.nber.org/papers/w4145.pdf>, 1.
[61] Margaret Blair and Lynn Stout, "A Team Production Theory of Corporate Law" (1999) 24 The Journal of Corporation Law 751, 763.
[62] Coase, supra note 49, 387.

abilities to exploit by giving property rights over their assets to one member.[63] The problem with this approach is that it still exposes other members to the exploitation of the controlling member, which reduces their incentives to produce to some extent.[64] The property right theory's solution to this problem is to give control to the most important member, so that losses from reduced incentives are minimized.[65] Thus the property right theory offers a second-best solution.

Alchian and Demsetz's solution was to give control to an outsider, who monitors the behavior of team members against opportunism.[66] The controlling actor is a residual claimant who receives what is left after the team members are paid. This encourages her to monitor to maximize the firm's profits.[67] But the controlling actor still has incentives to exploit other members by transferring value from them to herself.

Meanwhile, Williamson recognized that integration as a solution to the incomplete contracts problem has its own costs. Based on MacNeil's classification of contracts, Williamson argued that gaps in different types of contracts should be addressed differently. MacNeil realized that all contracts exist in a complex of relations.[68] But for some transactions, notably those which are likely to recur and involve transaction-specific investments, the relationships between contracting parties are of higher importance. MacNeil termed contracts covering these transactions relational contracts.[69] Contracts covering transactions which are not strongly influenced by the relationships between contracting parties are called discreet contracts.[70]

To Williamson, since there is little need to preserve the relationships between

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[63] Oliver Hart and John Moore, "Property Rights and the Nature of the Firm" (1990) 98 Journal of Political Economy 1119, 1132.
[64] Sanford Grossman and Oliver Hart, "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration" (1986) 94 Journal of Political Economy 691, 706.
[65] Ibid.
[66] Armen Alchian and Harold Demsetz, "Production, Information Costs and Economic Organization" (1972) 62 The American Economic Review 777, 781.
[67] Ibid, 782.
[68] Ian Macneil, "Relational Contract Theory: Challenges and Queries" (2000) 94 Northwestern University Law Review 877, 884.
[69] Ibid, 887.
[70] Ibid.

parties to discreet contracts, gaps in discreet contracts could be filled in the market by courts.[71] Meanwhile, parties to relational contracts have incentives to maintain their relationships. Litigation is adversarial and detrimental to the relationships between contracting parties. It is also slow while transactions might recur quickly. Hence parties to relational contracts would prefer a mechanism to fill contractual gaps expediently and in a friendly manner. In line with the property right theory, Williamson suggested that parties to relational contracts should integrate and have a controlling member to fill the gaps.[72] For some transactions, such as those which are non-recurring but involve transaction-specific investments, the relationships between contracting parties are important, but not important enough to justify integration. Williamson recommended arbitration as a dispute resolution mechanism.[73]

To summarize, most researchers consider integration, or the organizational power it creates, a solution to the problem of incomplete contracts, or the limitations of the market mechanism. Interestingly, Alchian and Demsetz denied the existence of power or hierarchies within firms.[74] They argued that within a firm an order to perform is actually an offer to contract. The subordinate can either accept the offer by following the instruction or refuse by exiting the firm. Hence what appears to be an exercise of power is indeed the making of a contract.[75] This argument can be defeated by Alchian and Demsetz's own claim later that the controlling actor has the ability to unilaterally alter the contracts of others,[76] which is essentially power.

Power could only be created in contracts by establishing agency or trust relationships. The relationships between shareholders and the company, or the board, are neither. Shareholders are not principals of the company. Principals in law are able to direct their agents, which is not the case even in the UK where shareholders have more power than in the US.[77] Directors are also not trustees of the company. Trustees

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[71] Oliver Williamson, "Transaction Cost Economics: The Governance of Contractual Relations" (1979) 22 The Journal of Law and Economics 233, 248.
[72] Ibid, 240.
[73] Ibid, 237.
[74] Alchian and Demsetz, supra note 66,777.
[75] Ibid.
[76] Ibid, 778.
[77] Lyman Johnson and David Million, "Recalling Why Corporate Officers Are Fiduciaries" (2005) 46

hold in their names the property of their beneficiaries. A company is a legal person and holds title to its property directly. Moreover, the priority of trustees is to safeguard trust property. Directors are entrepreneurs and have a duty to maximize the value of the company. To encourage their entrepreneurship, directors' duties are more relaxed than the duties of trustees.[78] As the relationships between shareholders and the company, or the board are neither agency nor trust, they are not purely contractual, but a product of the law. The company is similar to a nexus of contracts, but not merely a nexus of contracts. Viewing the company as such denies the role played by the law. Companies are characterized as such to support contractarians' argument against state intervention, which will be examined in section 3.

The rest of this section explores how incorporation mitigates the incomplete contracting problem. If shareholders and managers were to contract in the market, their contracts would be subject to severe incomplete contracting problems. Managers have incentives to act self-interestedly. They do not share the increased value of shareholders' assets. But when they act self-interestedly, they fully capture the benefits while the costs are borne by shareholders.[79] Shareholders could not anticipate and contractually prohibit all self-interested managerial behaviour. Two alternative courses of action are available to shareholders. The first is to align the interests of managers with shareholders' by paying managers in shares or performance-based remuneration.[80] The second approach is to monitor the behaviour of managers.[81] Both approaches are costly and not fully effective. Jensen and Meckling termed the sum of bonding costs, monitoring costs and residual losses as agency costs.[82] On the other hand, managers often make transaction-specific investments which could subject them to the exploitation of shareholders.[83] To mitigate these problems, shareholders and managers participate in the company.

William and Mary Law Review 1597, 1607.

[78] Leonard Sealy, "The Director as Trustee" (1967) Cambridge Law Journal 83, 89.

[79] Daniel Fischel, "The Corporate Governance Movement" (1982) 35 Vanderbilt Law Review 1259, 1262.

80 Jensen and Meckling, supra note 37, 308.

[81] Ibid.

[82] Ibid.

[83] John Coffee, "Shareholder versus Managers: The Strain in the Corporate Web" (1986) 85 Michigan Law Review 1, 19.

Shareholders give control over their capital to the company while managers give the company control over their human capital. The same applies to employees. To employ an independent worker, the contract has to specify the expected output. The contract would be very incomplete if the work is of an uncertain nature, subjecting both parties to the other's opportunism. This problem can be mitigated by transforming the independent worker to an employee, who gives control over her human capital to the company in exchange for fixed claims against the company.[84] Creditors also transfer ownership of their capital to the company for fixed claims in the form of payment of interest. Some creditors, such as small suppliers of big companies, are unable to renegotiate their contracts[85] and are subject to corporate power. Thus like shareholders, managers and employees, they are insiders of the company. Other creditors, such as banks, are not subject to corporate power and are outsiders of the company.

Therefore, the company is the controlling outsider in Alchian and Demsetz's theory, which monitors against corporate constituencies' opportunism. This appears to support the board control approach since the company acts through the board. This was the position taken by Blair and Stout. They viewed the board as a disinterested actor which should exercise corporate control to mediate disputes among corporate constituencies.[86] However, directors have agency problems themselves, which make complete board control undesirable. Thus shareholders should have power which allows them to mitigate the agency problem. But shareholders' exercise of power could also be short-term focused and prejudicial to other stakeholders. The optimal level of shareholder power should maximize its benefits and minimize the costs. As shareholders' exercise power in real life, the efficiency of shareholder activism should also be assessed by weighing its benefits to the costs. How the benefits and costs should be measured, especially whether the interests of other stakeholders should be taken into consideration, depends on what is the company's objective.

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[84] Orts, supra note 59, 304.
[85] Lucian Bebchuk, "Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics" (1997) 82 Cornell Law Review 1281, 1295.
[86] Blair and Stout, supra note 61, 774.

2. Corporate Objective

Contractarians are divided on what should be the company's objective. On the one side is shareholder wealth maximization, which argues that the company should be managed for the sole interests of shareholders. There are two main justifications for shareholder wealth maximization, neither of which are convincing. First, advocates for shareholder wealth maximization argued that shareholders are owners of the company.[87] However, the company is a legal person that cannot be owned. Shareholders are also not owners of corporate property. Ownership implies control.[88] Shareholders do not have control over issues such as the declaration of dividends.[89] Ownership also entails rights to exclude others from using the property.[90] Not only are shareholders incapable of excluding others, but minority shareholders can also be squeezed out.[91] In fact, shareholders transfer ownership of their capital to the company in exchange for shares, which are their property and give them certain rights in and against the company.[92] The company, as a legal person, is the owner of its property, which includes not only capital supplied by shareholders, but also capital supplied by other corporate constituencies. The company also owns assets created by itself, such as its reputation and organizational routines.[93]

The second justification for shareholder wealth maximization is that shareholders are the only residual claimants with incomplete contracts. Shareholder wealth maximization is considered protection for the particularly vulnerable shareholders.[94] However, as argued before, all corporate constituencies subject themselves to

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[87] Paul Davies, "Institutional Investors in the United Kingdom" in Dan Prentice and John Holland (eds) *Contemporary Issues in Corporate Governance* (OUP, 1993), 75.
[88] Paddy Ireland, "Company Law and the Myth of Shareholder Ownership" (1999) 62 The Modern Law Review 32, 55.
[89] Delaware General Corporation Law § 170.
Model Articles for Public Companies, Article 70.
[90] Iris Chiu, *The Foundations and Anatomy of Shareholder Activism* (Hart, 2010) 108.
[91] Delaware General Corporation Law § 253.
Companies Act 2006, section 979.
[92] Sarah Worthington, Shares and Shareholders: Property, Power and Entitlement" (2001) 22 Company Lawyer 258, 258.
[93]David Teece and Gary Pisano, "Dynamic Capabilities of Firm: An Introduction" (1994) 3 Industrial and Corporate Change 537, 538.
[94] Lynn Stout, "Bad and Not-so-Bad Arguments for Shareholder Primacy" (2002) 75 Southern California Law Review 1189, 1193.

corporate power via open-ended contracts and are all residual claimants, although other stakeholders do have fixed claims against the company whereas shareholders' claims are subordinated to the claims of other stakeholders. Thus shareholders can be considered ultimate residual claimants. But this does not mean that shareholders are more vulnerable than other stakeholders. Shareholders can sell their shares in a liquid market well before insolvency while exiting is more difficult for other stakeholders.[95]

The problem with shareholder wealth maximization is not that it precludes the company from promoting the interests of other stakeholder. As Chapter 2 showed, directors in both the US and the UK have wide discretion to decide what is in shareholders' best interests. They are free to promote other stakeholders' interests by sacrificing short-term shareholder value as long as doing so is in shareholders' interests in the long term. The problem with shareholder wealth maximization is that it also justifies transferring value from stakeholders to shareholders, such as to increase dividends by cutting employee salaries. As corporate constituencies participate in the company to mitigate exactly this type of behaviour, shareholder wealth maximization is not an appropriate corporate objective.

But a pure stakeholder approach would also be inappropriate. The stakeholder approach seeks to achieve Pareto efficiency,[96] that no corporate constituency can be made worse off. This could theoretically be achieved by having representatives of all corporate constituencies on the board. Co-determination in Germany is one step towards this direction. A typical German company has a two-tier board, with a managing board and a supervisory board, which appoints and removes managing directors.[97] Most companies with more than 500 but fewer than 2000 employees are required to have supervisory boards with one third of the directors representing employees and the rest representing shareholders. Companies with more than 2000 employees are required to have supervisory boards with equal representation of

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[95] Ronald Green, "Shareholders as Stakeholders: Changing Metaphors of Corporate Governance" (1993) 50 Washington and Lee Law Review 1409, 1418.

[96] Anthony Kronman, "Wealth Maximization as a Normative Principle" (1980) 9 Journal of Legal Studies 227, 233.

[97] Andreas Cahn and David Donald, *Comparative Company Law: Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA* (Cambridge University Press 2010), 302.

shareholders and employees.[98] As tradeoffs are often inevitable, this approach is too restrictive and could reduce corporate value. For example, Gordon and Schmid found that companies with equal shareholder and employee representation on their boards had a 31% discount on shareholder value.[99] This was partly caused by employee representatives' resistance against corporate restructuring and layoffs when the companies were in downturns, which reduced the companies' chances of recoveries.[100] Meanwhile, there was no conclusive proof that the reduction of shareholder value was made up by increased worker productivity.[101] Without codetermination, the stakeholder approach relies on managers to create value for all corporate constituencies.[102] But Berle's critique on Dodd's corporate social responsibility argument also applies here. Managers who are free to decide corporate objectives are likely to pursue private benefits and use corporate constituencies' conflicting interests to disguise their opportunism. This problem is termed the too-many-masters problem, as those who are responsible to many are often responsible to none.[103]

In the UK, section 172 of Companies Act 2006 requires directors to promote the success of the company in the form of shareholder interests while having regard to other stakeholders, commonly referred to as the enlightened shareholder value approach. The enlightened shareholder value approach is characterized as a third way, an intermediate approach between shareholder wealth maximization and the stakeholder approach.[104] Shareholder wealth maximization treats other stakeholders' interests as a means to achieve shareholder value. The stakeholder approach considers promoting the interests of other stakeholders an end itself with equal weight to

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[98] Ibid, 310.
[99] Gary Gordon and Frank Schmid, "Capital, Labor and the Firm: A Study of German Codetermination" (2004) 2 Journal of the European Economic Association 863, 879.
[100] Ibid, 889.
[101] Ibid 890.
[102] Henry Hansmann and Reinier Kraakman, "The End of History for Corporate Law" (2001) 89 The Georgetown Law Review 439, 447.
[103] Kent Greenfield, "The Third Way" (2014) 37 Seattle University Law Review 749, 768.
[104] Cynthia Williams and John Conley, "An Emerging Third Way: The Erosion of the Anglo-American Shareholder Value Construct" (2005) 38 Cornell International Law Journal 483, 499.

shareholder value.[105] The enlightened shareholder value approach treats other stakeholders' interests as an end itself, but subordinates it to shareholder value.[106] The result is that enlightened shareholder value is very much like shareholder wealth maximization. Transferring value from stakeholders to shareholders is still justified. The only difference between the two approaches lies in the rare case where there are two projects which are equally beneficial to shareholders. If one also promotes the interests of other stakeholders, a company under the enlightened shareholder value approach would be obligated to choose that project, while a company under a pure shareholder value approach is free to choose either.[107]

As all corporate constituencies benefit from the company's increased value, the company's objective should be total utility maximization. This approach is similar to the entity maximization and sustainability model proposed by Keay.[108] But it is different from Moore and Petrin's total wealth maximization model,[109] because it encompasses both pecuniary and non-pecuniary benefits, such as happiness and job security.[110] Since this objective focuses on the creation of value, simply transferring value from one corporate constituency to another would not be justified. But unlike the stakeholder approach, total utility maximization allows for necessary tradeoffs, as long as the benefits of some corporate constituencies outweigh the losses of others. Thus this approach seeks to achieve Kaldor-Hicks efficiency.[111] The major problem with this approach is how to measure total utility. Most benefits other stakeholders get from the company are non-pecuniary. But in the long term they all translate into shareholder wealth. Suppose a company in financial distress raises capital by cancelling dividends instead of laying off employees. The gains of the employees, which depend on how much they value their jobs, cannot be quantified and compared

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[105] Andrew Keay, *The Enlightened Shareholder Value Principle and Corporate Governance* (Routledge, 2013) 62.
[106] Ibid, 44.
[107] Ibid, 131.
[108] Andrew Keay, "Ascertaining the Corporate Objective: An Entity Maximization and Sustainablility Model" (2008) 71 Modern Law Review 663.
[109] Marc Moore and Martin Petrin, *Corporate Governance: Law, Regulation and Theory* (Red Globe Press, 2017) 42.
[110]Richard Posner, "The Ethical and Political Basis of the Efficiency Norm in Common Law Jurisdiction" (1980) 8 Hofstra Law Review 487, 488.
[111] Ibid, 491.

with the dividend cut. But employees who benefit are likely to be more loyal and productive. In the long term the company will have improved performance if the total utility of shareholders and employees is increased. Therefore, as long as there is no value transfer, total utility is the same as long-term shareholder value. Such a clear measure of total utility mitigates the concern for managerial accountability. Following this approach, later chapters will assess the efficiency of shareholder activism by weighing its benefits and costs to the company, in the form of shareholder value in the long term.

III. Mechanisms to Address the Agency Problem

1. The Law

Viewing the company as a nexus of contracts, contractarians argue against state intervention of corporate affairs as it distorts free contracting.[112] According to the contractarian theory, company law should only seek to facilitate contracts by mitigating market failures, mostly information asymmetry and transaction costs.[113]

If the market is strongly efficient, that a company's share price promptly reflects all information, there would be no information asymmetry between shareholders and managers. But since the market is not strongly efficient,[114] managers are at an informational advantage *vis-à-vis* shareholders. Currently the law mitigates this problem via mandatory corporate disclosure. Opponents argued that mandatory corporate disclosure is unnecessary. Companies have incentives to disclose information voluntarily.[115] Most companies are willing to disclose positive information to attract investors. They also have incentives to disclose negative information as investors tend to assume the worst from the company's prolonged

[112] Marc Moore, "Private Ordering and Public Policy: The Paradoxical Foundations of Corporate Contractarianism" (2014) 34 Oxford Journal of Legal Studies 693, 707.
[113] Christopher Riley, "Understanding and Regulating the Corporation" (1995) 58 Modern Law Review 595, 606.
[114] See Part 4 of this Section.
[115] Frank Easterbrook and Daniel Fischel, "Mandatory Disclosure and the Protection of Investors" (1984) 70 Virginia Law Review 669, 680.

silence.[116] Securities analysts and financial press are dedicated to information discovery. When they expose negative information which was not disclosed by the company, investors generally punish the company by further discounting its value.[117] This incentivizes managers to disclose negative information voluntarily. Thus opponents against mandatory corporate disclosure believe that information which is not voluntarily disclosed is of no value to investors and increases companies' costs.

However, opponents have not taken into consideration the fact that corporate disclosure is controlled by managers whose interests might diverge from the company's. For example, managers contemplating to purchase controlling shares of the company have no incentive to disclose this information because uninformed shareholders are likely to sell their shares at a lower price.[118] Moreover, in practice investors understand that some information cannot be disclosed without reducing their value and do not always discount corporate value for non-disclosure.[119] Information discovery of securities analysts is also not fully effective. Information is a public good. Once a piece of information is produced and traded on, other investors could observe and trade on the information as well. Their free-riding reduces information producer's incentive to uncover information, resulting in underproduction of information.[120] Mandatory disclosure reduces the cost of information production and consequently increases information discovery.[121] In addition, several securities analysts might be working to produce the same piece of information. This duplication of effort is wasteful and could be mitigated by mandatory disclosure.[122] Therefore mandatory corporate disclosure is essential to mitigating information asymmetry.

Contractarians believe that company law can reduce transaction costs by providing rules which contracting parties would reach to themselves in hypothetical

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[116] Ibid, 683.
[117] Elisabeth Dedman and Stephen Lin, "Shareholder Wealth Effects of CEO Departures: Evidence from the UK" (2002) 8 Journal of Corporate Finance 81, 81.
[118] John Coffee, "Market Failure and the Economic Case for a Mandatory Disclosure System" (1984) 70 Virginia Law Review 717, 743.
[119] Ibid, 741.
[120] Ibid, 725.
[121] Ibid.
[122] Ibid, 733.

bargains.[123] Mandatory rules should be what all parties would agree to. Default rules should be what the majority would agree to. The minority could contract out of such rules.[124] Hence company law saves contracting costs by providing a set of standard-form contracts.[125] As in this view company law only seeks to mimic the market, it is considered trivial.[126]

The contractarian theory argues against state intervention because it believes that efficient outcomes could be achieved via private ordering. But by implementing rules which rational parties would agree to in hypothetical bargains with no information asymmetry and transaction cost, it has already acknowledged that these efficient outcomes cannot be achieved in real bargains.[127] Moreover, the outcomes of hypothetical bargains could only be assumed, based on common values and social expectations, which are shaped by the state.[128] Therefore, rather than mimicking what contracting parties want, company law reduces transaction costs by having rules which the state wants. As argued by Moore, although direct state intervention is not common, companies certainly operate in the shadow of the state.[129]

Contractarians are divided on whether the agency problem has been effectively controlled. There are three main mechanisms against the agency problem, board monitoring, incentive alignment and market discipline. If these mechanisms are sufficiently effective, there would be no need for shareholder activism.[130] The rest of this section conducts this analysis.

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[123] David Charny, "Hypothetical Bargains: The Normative Structure of Contract Interpretation" (1991) 89 Michigan Law Review 1815, 1836.
[124] Ian Ayres and Robert Gertner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules" (1989) 99 The Yale Law Journal 87, 91.
[125] Ibid.
[126] Bernard Black, "Is Corporate Law Trivial? A Political and Economic Analysis" (1990) 84 Northwestern University Law Review 542, 552.
[127] Marc Moore, *Corporate Governance in the Shadow of the State* (Hart, 2013), 241.
[128] Ibid, 254.
[129] Ibid.
[130] Stephen Bainbridge, Shareholder Activism and Institutional Investors, UCLA School of Law, Law and Economics Research Paper No. 05-20, Accessed on April 21, 2019 at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=796227>, 7.

2. Board Monitoring

The board is supposed to monitor managers and within itself against the agency problem. The advantage of having a group on top of the corporate hierarchy is group monitoring. The board is a relatively small group where each director's agency problem or incompetence in monitoring is more observable. This incentivizes directors to act responsibly as people generally value how they are perceived by peers.[131]

Board monitoring used to be ineffective as managers controlled directors' nomination and remuneration. Directors were also likely to be too connected with managers to monitor objectively. These problems are mitigated by the introduction of independent directors. Independent directors are also called outside directors or non-executive directors. Independent directors have no relationship with the company (such as being its shareholders) other than attending board or committee meetings and receiving payments for attendance. In the US, the NYSE and NASDAQ require listed companies to have boards with a majority of independent directors[132] and independent committees on nomination,[133] compensation[134] and audit.[135] In the UK, companies listed in the London Stock Exchange must comply with the Corporate Governance Code or explain for non-compliance.[136] The Code suggests that a board should have a majority of non-executive directors and a senior non-executive director who leads the non-executive directors.[137] A company should also have independent committees on nomination,[138] audit[139] and remuneration.[140] As they have no other tie

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[131] Stephen Bainbridge, "Why a Board: Group Decisionmaking in Corporate Governance" (2002) 55 Vanderbilt Law Review 1, 36.
[132] The New York Stock Exchange Listed Company Manual 303A.01; NASDAQ Stock Market Rules 5600(b)(1).
[133] Ibid, 303A. 04; 5600(e).
[134] Ibid, 303A. 05; 5600(d).
[135] Ibid, 303A. 06; 5600(c).
[136] FCA Handbook, Listing Rules 9.8.6(5).
[137] Financial Report Council, The UK Corporate Governance Code (July 2018), A.4.1.
[138] Ibid, B.2.1.
[139] Ibid, C.3.1.
[140] Ibid, D.1.1.

with the company, independent directors can monitor more objectively.[141] Subjecting directors' nomination and remuneration to the control of independent committees also reduces managing directors' reliance on managers, increasing the effectiveness of board monitoring.

However, board monitoring is still not fully effective. First, many independent directors and independent committees are not truly independent from managers. For example, most independent committees make decisions by choosing from a list of options prepared by personnel who answer to the management, such as human resources officers, remuneration consultants and headhunters.[142] Hence managers still have considerable influence over directors. Moreover, a large percentage of independent directors are retired managers or incumbent managers of other companies who dislike scrutiny of their boards. This might make them empathetic to managers and refrain from monitoring.[143]

Second, to preserve independence, independent directors only attend board and committee meetings. They depend on information provided by the management and their understanding of the company's business is likely to be limited. This often makes independent directors unconfident to challenge managers.[144]

Third, boards are highly homogenous, which gives rise to the group think problem.[145] In a diverse group where each member approaches a problem differently, the merits and problems of each option are likely to be identified and the group would be able to reach a decision better than any individual decision.[146] But members of a homogenous group approach problems in similar ways. Instead of cancelling out biases and mistakes, group decision-making makes members more confident in their

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[141] Sarah Kiarie, "Non-Executive Directors in UK Listed Companies: Are They Effective?" (2007) 18 International Company and Commercial Law Review 17, 18.

[142] Michel Jensen and Kevin Murphy, Remuneration: Where We've Been, How We Got Here, What Are the Problems and How to Fix Them? ECGI Working Paper Series in Finance 44/2004 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=561305 >, 50.

[143]Lewis Solomon, "Restructuring the Corporate Board of Directors: Fond Hope—Faint Promise?" (1978) 76 Michigan Law Review 581, 596.

[144]Saleem Sheikh, "Non-Executive Directors: Self-Regulation or Codification?" (2002) 23 Company Lawyer 296, 297.

[145] Marleen O'Conner, "The Enron Board: The Perils of Groupthink" (2003) 71 University of Cincinnati Law Review 1233, 1233.

[146] Bainbridge, supra note 131, 21.

decisions and the group is likely to reach more polarized decisions.[147]

Fourth, board monitoring has costs which vary for different companies. Decision-making would be slower if managers have to explain their decisions to the board and gain its approval.[148] This would not be a problem for companies operating in stable environments. But for companies which need to adapt to changes quickly, intensive board monitoring would be highly cumbersome. Moreover, although most independent directors have business expertise, they do not always have knowledge specific to the company and its business. This generally does not prevent independent directors from effectively reviewing managerial decisions when the company's business is more of a generic nature. But independent directors are less capable to do so in companies whose business is unique or requires much background knowledge to be understood. Subjecting these companies to intensive monitoring of ill-informed independent boards is likely to impose more costs than benefits.[149] Besides monitoring, the board also has an advisory role.[150] Managers are unlikely to seek advice from a board which monitors overly intensively, because they fear that the board would use the information they disclosed to challenge their decisions later.[151] The balance between the board's monitoring and advisory function is heavily influenced by the company's culture. Managers of companies with more adversarial cultures are more accustomed to being challenged and would be comfortable with intensive board monitoring than managers of companies with gentler cultures.

3. Incentive Alignment

Previously, corporate managers were paid mostly fixed amounts of salaries, the size of which depended mainly on the size of the companies. This resulted in

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[147] O'Conner, supra note 145, 1256.
[148] Arnound Boot and Jonathan Macey, "Monitoring Corporate Performance: The Role of Objectivity, Proximity and Adaptability in Corporate Governance" (2004) 89 Cornell Law Review 356, 373.
[149] Olubunmi Faleye, Does One Hat Fits All? The Case of Corporate Leadership Structure, Accessed on April 24, 2019 at <https://pdfs.semanticscholar.org/20db/c9770a46be3007aab8d74abbbf49873f6d99.pdf>, 6.
[150] Boot and Macey, supra note 148, 357.
[151] Olubunmi Faleye, Rani Hoitash and Udi Hoitash, "The Costs of Intense Board Monitoring" (2011) 101 Journal of Financial Economics 160, 160.

managers building empires which contributed to waves of takeovers in the US and the UK.[152] The wide acceptance of the agency theory and its bonding mechanism led to managers being paid largely in incentive payments, which remains the common practice today.

In the US, managers are most commonly paid in share options, which give them the right to purchase a certain number of shares at a particular price in a certain period of time.[153] Compared to granting managers' ordinary shares, share options motivate managers to increase the company's share value as well, but limit their downside risk. Managers might also participate in long-term incentive plans. Under such plans, ownership of shares is vested after the shares being held for certain years or upon the attainment of certain performance targets.[154] Managers also receive bonuses upon the attainment of certain performance targets. In the UK, long-term incentive plans are favoured over share options as the main method of incentive alignment.[155] The Corporate Governance Code recommends a five year vesting or holding period.[156] It also encourages companies to recover payments from managers when corporate performance reverses in the short term.[157] The hope in both the US and the UK is that by paying managers performance-based remuneration and in shares, managerial interests would be aligned with shareholder interests, which incentivizes managers to control the agency problem voluntarily.

However, incentive alignment is not fully effective. Managers have informational advantage which enables them to foresee to some extent corporate performance. They have incentives to act self-interestedly when the benefits, mostly in the form of remuneration, outweigh the losses[158] Suppose the company has £100 million to invest and is deciding which of the two projects to invest in. Project A has a

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[152] Jensen and Murphy, supra note 142, at 27.
[153] Ibid, 57.
[154] Ibid.
[155] Martin Conyon and Kevin Murphy, "The Prince and the Pauper? CEO Pay in the United States and United Kingdom" (2000) 110 The Economic Journal 640, 641.
[156] The Corporate Governance Code, supra note 137, Provision 36.
[157] Ibid, Provision 37.
[158] Lucian Bebchuk, Alma Cohen and Holger Spamann, "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008" (2010) 257 Yale Journal on Regulation 257, 273.

85% chance of making and a 15% chance of losing £20 million in the first year. It has a fifty-fifty percent chance of making or losing £50 million in the second year. It has a 15% chance of making and a 85% chance of losing £100 million in the third year. Project B has a 90% chance of making and a 10% chance of losing £15 million each year.

Table 1

	Project A		Project B	
	Probability	Project Value（£ million）	Probability	Project Value（£ million）
Year 1	15%	80	10%	85
	85%	120	90%	115
Year 2	7.5%	30	1%	70
	42.5%	170	18%	100
	50%	70	81%	130
Year 3	6.375%	-70	0.1%	55
	36.125%	-30	2.7%	85
	6.375%	30	24.3%	115
	36.125%	70	72.9%	145
	1.125%	130		
	6.375%	170		
	1.125%	230		
	6.375%	270		

As shown in Table 1, at the end of the third year, the expected value of Project A is £44 million while the expected value of Project B is £136 million. Managers acting in the company interests should choose Project B. But if Project A generates positive cash flows in the first and second year, the increase in the company's profitability and share price would be much larger than in the Project B scenario and managers would have more remuneration. Knowing that the share price is most likely to drop in the third year, managers can sell their shares when the price is at its peak. Managers

whose bonuses and trading profits outweigh their losses in the third year have incentives to choose Project A.

Excessive incentive alignment encourages managers to manipulate corporate performance. Managers who wish to meet performance targets have incentives to increase the company's short-term value by sacrificing its value in the long term.[159] As the exercise price of share options is often set at the share price on the day the options are granted, managers who anticipate the granting of options have incentives to depress the company's share price.[160] Empirical studies did find that earnings management was more prevalent in companies with high pay-performance sensitivity.[161]

Incentive alignment is costly. Managers are risk-averse as they have invested most of their human capital into the company and cannot diversify.[162] Performance-based remuneration and equities are risky because some factors affecting the company's performance are outside managers' control. Companies have to offer payments whose expected value is higher than fixed payments to compensate managers for bearing these risks. The cost of incentive alignment is likely to increase with companies' risk levels.[163] The benefits brought by incentive alignment, namely the reduction of agency costs, also vary across companies. Companies which are subject to intensive board or market discipline would have fewer needs for incentive alignment than other companies.[164] Thus like the level of board monitoring, the optimal level of incentive alignment is also highly firm-specific.

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[159] Lucian Bebchuk and Jesse Fried, "Paying for Long-Term Performance" (2010) 158 University of Pennsylvania Law Review 1915, 1924.
[160] Ibid, 1914.
[161] Bruno Frey and Margit Osterloh, "Yes, Managers should be Paid like Bureaucrats" (2005) 14 Journal of Management Inquiry 96, 97.
[162] Coffee, supra note 83, 17.
[163] Samuel Gray and Albert Cannella, "The Role of Risk in Executive Compensation" (1997) 23 Journal of Management 517, 523.
[164] Andrew Ward, Jill Brown and Dan Rodriguez, "Governance Bundles, Firm Performance and the Substitutability and Complementarity of Governance Mechanisms" (2009) 17 Corporate Governance: An International Review 646, 648.

4. Market Discipline

A company is subject to the discipline of the product market, the capital market and the market for corporate control. Managers are also subject to the discipline of the labour market. But none of these mechanisms are fully effectively.

As will be discussed in Chapter 5, the corporate governance function of the product market depends on its competitiveness. This means that companies in relatively concentrated markets would not be effectively disciplined by the product market.

The capital market includes the debt market and the equity market. As managers with high agency costs increase the probabilities of insolvency, creditors would ask for higher interest rates or subject their companies to stricter covenants. This might incentivize managers to control agency costs themselves or lead to their removal.[165] However, companies can be insulated from the debt market by hoarding free cash flows.[166]

The equity market is considered a major mechanism to mitigate agency costs. A company's agency costs are negatively correlated to its share price.[167] As a low share price paints a picture of managerial incompetence and reduces executive remuneration, managers have incentives to reduce agency costs themselves.[168] The market for corporate control is another powerful mechanism to address the agency problem. Manne argues that when a company's share price decreases to a certain point, other companies which believe that they can utilize the company's resources more efficiently would take control of the company and replace its managers. The fear of losing their jobs should encourage managers to control agency costs voluntarily.[169]

Whether the market is an effective corporate governance mechanism depends on whether the market is efficient. Market efficiency has two meanings. First, the market

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[165]Michael Jensen, "Agency Costs of Overvalued Equity" (2005) 34 Financial Management 5, 13.
[166] Michael Jensen, "Agency Costs of Free Cash Flow, Corporate Finance and Takeover" (1986) 76 The American Economic Review 323, 323.
[167] Jensen and Meckling, supra note 37, 315.
[168] Coffee, supra note 83, 26.
[169] Henry Manne, "Mergers and the Market for Corporate Control" (1965) 73 Journal of Political Economy 110,112.

is efficient when a company's share price reflects all available information. The scope of information incorporated in the company's share price determines the level of market efficiency. According to the categorization of Fama, the market is efficient in the weak form when the share price is only able to reflect past information, in the semi-strong form when it can reflect public information and in the strong form when it reflects both public and non-public information.[170] For the market to be an effective corporate governance mechanism, it must be able to reflect non-public information, such as managerial capabilities. In other words, the market must be strongly efficient. Second, the less time the market takes to reflect a piece of information, the more efficient it is.[171]

The question that naturally follows is how is information reflected into price. Gilson and Kraakman identified four mechanisms, which mechanism works for which type of information depends on the information' cost. Information costs include the cost to acquire, process and verify information.[172] Information which is publicly disclosed and whose authenticity is ensured by the law has little acquisition or verification cost. Investors almost trade instantly on public information which is easy to understand, such as takeover announcements. Hence the market is efficient for public information with low processing costs.[173]

Other types of public information, such as earnings reports, require financial knowledge to be interpreted. Most retail investors do not trade promptly on this type of information because they are unable or unwilling to incur the high processing cost.[174] Professional investors, such as traders and securities analysts process the information and trade on it. Their trading would be large enough to reflect the information in prices, but there will be a time lag between disclosure of the information and its reflection in share prices. Thus although the market is still

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[170] Eugene Fama, "Efficient Capital Market: A Review of Theory and Empirical Work" (1970) 25 Journal of Finance 383, 414.
[171] Lynn Stout, "The Mechanism of Market Inefficiency: An Introduction to New Finance" (2003) 28 Journal of Corporation Law 635, 639.
[172] Ronald Gilson and Reinier Kraakman, "The Mechanisms of Market Efficiency" (1984) 70 Virginia Law Review 549, 594.
[173] Ibid, 568.
[174] Ibid, 569.

efficient for public information, its level of efficiency drops with the increase of processing cost.[175]

Professional investors often spend high acquisition costs to uncover non-public information. Corporate insiders also trade frequently. Such trading on non-public information is unlikely to be large enough to influence prices.[176] Other investors might be able to observe the transactions, decode the information underlying the trade or simply copy the transactions, thus translating the information into price. But market noise often limits their ability to do so. Therefore the market is only relatively efficient for non-public information.[177] But in another light, the limited ability of other investors to free-ride non-public information also motivates investors to incur the high acquisition costs to produce more information, which ultimately improves market efficiency.[178]

Investors have different information sets and views on the company's value. They also make various kinds of mistakes. The market aggregates all information and cancels out investors' biases. In this light, the market is efficient and the share price is the best estimation of the company's value.[179] However, this mechanism has several flaws. First, systematic biases might be developed which cannot be canceled out. For example, Moore believes that currently the market is systematically myopic.[180] Second, this mechanism works best when all investors trade following exactly their own views. But in practice investors have limited wealth to invest. Risk-aversion might also prevent them from acting fully on their visions, especially when doing so requires going against the market.[181] For instance, Brunnermeier and Nagel found that hedge funds which had predicted the dotcom bubble chose to the ride the bubble and sold their positions before the bubble burst rather than short selling shares of

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[175] Ibid.
[176] Ibid, 572.
[177] Ibid, 573.
[178] Ibid, 624.
[179] Ibid, 580.
[180] Marc Moore and Edward Walker-Arnott, "A Fresh Look at Stock Market Short-Termism" (2014) 41 Journal of Law and Society 416, 420.
[181] Lynn Stout, "The Mechanisms of Market Inefficiency: An Introduction to the New Finance" (2003) 28 Journal of Corporation Law 635, 647.

overvalued Internet companies.[182] Restrictions on short-selling further reduce market efficiency.[183] Both the US and the EU disallow short sales of shares which have not been borrowed and located with brokers *ex ante*.[184] Regulators in both jurisdictions also have power to temporarily ban short selling in extreme market conditions.[185]

The examination of the mechanisms for market efficiency has shown that the market can be inefficient. This observation is also supported by real life experience. If the market is strongly efficient, that is if all non-public information is instantly reflected on the company's share price, insiders would not be able to outperform other investors.[186] But in reality insiders who trade on their knowledge about the company's future plans make significant abnormal returns.[187]

The level of market efficiency differs for different companies. Valuation of companies with unique assets incurs high information processing costs. Small and young companies are likely to be covered by fewer securities analysts. The market would be less efficient and its discipline would be weaker for these companies than for large mature companies with generic products.[188]

Meanwhile, the market for corporate control can be ineffective even when the capital market is strongly efficient. Takeovers entail significant costs. An acquirer must investigate a number of companies to identify a suitable target. It needs to design business combination plans and takeover strategies and in doing so bear the cost of disruption to its own business.[189] The share price of acquirers who fail in takeovers often drops as investors assume that all the resources put into takeovers are

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[182] Markus Brunnermeier and Stefan Nagal, "Hedge Funds and the Technology Bubble" (2004) The Journal of Finance 2013, 2014.

[183] Elizabeth Howell, "Short Selling Restrictions in the EU and the US: A Comparative Analysis" (2016) 16 Journal of Corporate Law Studies 333, 362.

[184] 17 CFR § 242. 203.

Regulation (EU) No 236/2012 of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps [2012] OJ L86/1, Article 12.

[185] Regulation 236/2012, Article 2 and 28.

17 CFR § 242. 201.

[186]Michael Wachter, "Takeover Defense when Financial Markets are (Only) Relatively Efficient" (2003) 151 University of Pennsylvania Law Review 787, 802.

[187] See Chapter 6.

[188]John Coffee, "Market Failure and the Economic Case for a Mandatory Disclosure System" (1984) 70 Virginia Law Review 717, 731.

[189] Frank Easterbrook and Daniel Fischel, "The Proper Role of a Target's Management in Responding to a Tender Offer" (1981) 94 Harvard Law Review 1161, 1178.

wasted. It is not uncommon that failed acquirers become targets themselves.[190]

Takeover regulation faces two challenges. First, agency problem is exacerbated in takeovers as managers' private interests, namely the preservation of their jobs and accompanying benefits, are much larger than in normal business situations.[191] If managers are free to decide whether to accept takeover offers, they are likely to frustrate value-increasing acquisitions. On the other hand, rather than the majority rule, each shareholder decides whether to tender their shares. This exacerbates the collective action problem and gives acquirers opportunities to push through takeovers which decrease the target's value.[192] For example, an acquirer could make an inadequate offer for the target and plans to sell the target in pieces once it is taken over. It is in the collective interests of target shareholders not to sell their shares. But absent effective communication, an individual shareholder might sell her shares at the inadequate price out of the fear that she would be worse off if the takeover goes through.

The free-rider problem is also exacerbated. An acquiring company must offer target shareholders a premium to induce them to sell. But for the takeover to be profitable, the premium should be lower than the share's post-takeover value. Realizing that, shareholders might choose to free-ride the post-takeover value by not selling their shares.[193] If shareholders can cooperate by each holding a proportion of shares while still selling enough share for the takeover to be completed, their free-riding would not be a serious problem. Since dispersed shareholders cannot collaborate effectively, even takeovers which are beneficial to target shareholders might not succeed. The high probability of failure and high takeover costs reduce acquirers' incentives to make takeover offers.[194]

Therefore, takeover regulation must decide which problem is more damaging. The US focuses on the collective action problem and gives boards discretion to

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[190] Ibid.

[191] Paul Davis, Klaus Hopt and Wolf-Georg Ringe, "Control Transactions" in Reinier Kraakman et al (eds) *The Anatomy of Corporate Law* (3rd OUP,2017) 207.

[192] Ibid.

[193] Sanford Grossman and Oliver Hart, "Takeover Bids, The Free-Rider Problem and the Theory of the Corporation" (1980) 11 The Bell Journal of Economics 42, 43.

[194] Ibid.

frustrate takeovers which they believe are value-decreasing. The UK is keener to minimize agency costs and prohibits most takeover defences. But both approaches result in high takeover costs. In the US acquirers have to incur high costs to overcome takeover defences. In the UK, shareholders' collective action problem means that even beneficial offers are likely to fail.

Because takeovers have high costs, they do not just happen because acquirers believe they can create more value from targets' assets, but for more strategic reasons, such as synergies between the two companies or economies of scale of the merged company.[195] High takeover costs also make acquirers shy away from companies with most severe problems. Given that the market is not strongly efficient, a company's agency problem must be quite serious for it to be reflected in the share price. This, combined with acquirers' risk-aversion, mean that the disciplinary effect of hostile takeovers is only limited to companies whose agency problems are serious, but not too serious to make turnarounds improbable.[196]

Managers compete for employments. Those with high agency costs might be replaced by candidates in the labour market. Removed managers might experience negative consequences in the labour market.[197] However, the functioning of the labour market depends on other governance mechanisms. Managers are only likely to suffer negative consequences in the labour market if they are removed by the board or hostile takeovers. Thus the discipline of the managerial labour market is also not fully effective.

IV. Conclusion

This chapter established a theoretical framework of the company upon which future analysis of shareholder activism is based. It argued that a company is similar to a nexus of contracts. The difference between a pure nexus of contracts and a company

[195] Frank Easterbrook and Daniel Fischel, "The Proper Role of a Target's Management in Responding to a Tender Offer" (1981) 94 Harvard Law Review 1161, 1185.
[196] Ibid, 1204.
[197] UyacheslavFos and Margarita Tsoutsoura, "Shareholder Democracy in Play: Career Consequences of Proxy Contests" (2014) 114 Journal of Financial Economics 316, 317.

lies in corporate power. Corporate constituencies participate in the company because contracting in the market would be incomplete. To minimize opportunism arising from contractual gaps, corporate constituencies give power to the company. The company, through its board, should monitor against corporate constituencies' opportunistic behavior. But directors have agency problems themselves, making complete board control undesirable. Thus the optimal level of shareholder power should reduce agency costs at the minimal costs to the company.

As the company is formed to prevent opportunism, shareholders should not be allowed to transfer value from other stakeholders to themselves. Hence this chapter adopts total utility maximization as the company's objective, in the form of maximization of shareholder value in the long term. Based on this objective, whether shareholder activism is efficient depends on its costs and benefits to the company. The level of the benefits depends on the effectiveness of existing mechanisms against the agency problem, namely board monitoring, incentive alignment and market discipline. This chapter concluded that they are not fully effective, which creates room for another corporate governance mechanism. Whether shareholder activism can be that mechanism depends on whether its benefits outweigh the costs. Chapter 4 conducts this analysis.

Chapter 4 Efficiency or Inefficiency of Institutional Shareholder Activism

The previous chapter argued that the company's objective should be the maximization of corporate constituencies' total utility, in the form of shareholder value in the long term. The optimal level of shareholder power should maximize its benefits at the minimal cost to the company. As shareholders' exercise power in real life, the efficiency of shareholder activism should be assessed by comparing its costs and benefits to the company. This chapter studies the benefits and costs of shareholder activism in general. The next chapter will examine how specific factors of target companies affect the efficiency of shareholder activism.This chapter is organized as follows.

Section I examines the benefits of shareholder activism, which lie in its function as an independent corporate governance mechanism and its improvement to other corporate governance mechanisms, namely board monitoring, incentive alignment and market discipline. Section II, III and IV examine costs of institutional shareholder activism, which are self-interested activism, short-termist activism and negative externalities. Section V reviews empirical evidence on the efficiency of shareholder activism. Section VI concludes.

I. Improvement to Corporate Governance

1. Board Monitoring

Different types of institutional shareholders can improve board monitoring in different ways. Public pension funds frequently submit proposals to promote board structures which they believe are inductive to effective monitoring. In the US, Smith found that 9% of proposals submitted by California Public Employees' Retirement System aimed to increase board independence.[1] Becht *et al* studied shareholder activism engaged by Hermes, a pension scheme for staff of British

[1] Michael Smith, "Shareholder Activism by Institutional Investors: Evidence from CalPERS" (1996) 51 The Journal of Finance 227, 234.

Telecommunication and the Post Office. They found that Hermes had the appointment of independent directors as one of its objectives in 60% of cases.[2]

Although other mainstream institutional shareholders are less engaged, they do act when it comes to board structures. For example, in 2008, Marks & Spencer, a UK retailer, nominated its CEO, Sir Stuart Rose, as chairman of the board. The nomination was publicly opposed by the Association of British Insurers,[3] since following the Corporate Governance Code, the person leading board monitoring should not be the subject of the monitoring.[4] Nevertheless, Sir Stuart Rose was elected chairman, with approximately 5% of votes cased against him and 17% abstentions.[5] In 2009, the Local Authority Pension Fund Forum, an association of public pension funds in the UK, tabled a resolution to replace Sir Stuart Rose with an independent chairman. The resolution did not pass but gained support from approximately 38% of shares. Sir Stuart Rose later agreed to retire early.[6]

Unlike mainstream institutional shareholders which focus on board structures, hedge funds replace directors whom they believe are inefficient with directors of their choosing. Directors appointed by hedge funds could add diversity to the board and mitigate the group-think problem. This type of activism would be particularly beneficial to companies with insular culture, where senior positions are often filled by internal promotions rather than external hires. For example, Trian Fund Management succeeded in 2017 in appointing its fund manager, Nelson Peltz, to the board of Procter & Gamble, a multinational consumer goods company.[7] One of its reasons

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[2] Marco Becht, Julian Franks, Colin Mayer and Stefano Rossi, "Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes Focus Fund" (2009) 22 The Review of Financial Studies 3093, 3112.

[3] Jill Treanor and Julia Finch, Shareholder Unease at Elevation of Chairman Rose, The Guardian (March 11, 2008).

[4] Financial Reporting Council, The UK Corporate Governance Code (July 2018), A.2.1.

[5] James Thompson, "One in Four M&S Shareholders Fails to Support Rose" The Independent (July 10, 2018).

[6] The Chronicle, Shareholder Activism: A Necessary Bitter Pill (October 23, 2011).

[7] Aneliya Crawford, Brandon Gold and Daniel Goldstein, Lessons Learned from Trian's Campaign at Procter & Gamble, Harvard Law School Forum on Corporate Governance and Financial Regulation, March 25, 2018, Accessed on April 10, 2019 at <https://corpgov.law.harvard.edu/2018/03/25/lessons-learned-from-trians-campaign-at-procter-gamble/>.

behind the activism was that P&G's enclosed culture prevented the board from understanding changes in the market place. An outside director like Peltz could bring fresh perspectives and remedy the situation.[8] The performance of P&G did improve after the activism.[9]

Hedge fund activism can also strengthen the discipline of directors' labour market. Fos and Tsoutsoura found that directors who were removed by proxy contests suffered negative consequences in the labour market, such as losing board seats and having smaller remuneration in other companies.[10] The negative effect was more serious on independent directors than on inside directors,[11] which should encourage independent directors to monitor more diligently.

In most cases hedge funds make boardroom changes to push for their plans for target companies. Hence changes in corporate value after such activism are more likely to reflect the qualities of these plans, rather than board effectiveness. In other words, there is little evidence of hedge fund activism's effect on board monitoring. A few studies examined market reaction to activism on board structures and reached mixed conclusions. For example, Becht *et al* found negative but insignificant market reaction to the appointment of independent directors after the activism of Hermes.[12] Meanwhile, Filatotchev and Dotsenko found significant and positive market reaction to boardroom changes led by shareholders.[13] Other than their methodological limitations,[14] one explanation for the contradicting studies is that the level of optimal board monitoring varies for different companies. The previous chapter suggested that some companies, such as companies operating in fast-changing environments, companies with unconventional business or congenial culture might benefit from low

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[8] Trian Partners, Revatalize P&G Together, September 6, 2017 Accessed on April 10, 2019, at <https://trianpartners.com/content/uploads/2017/01/Trian-PG-White-Paper-9.6.17-1.pdf>, 72.
[9] Geoff Colvin, "The Investor that Tripped on GE and P&G", Fortune (November 26, 2018).
[10] UyacheslavFos and Margarita Tsoutsoura, "Shareholder Democracy in Play: Career Consequences of Proxy Contests" (2014) 114 Journal of Financial Economics 316, 317.
[11] Ibid, 318.
[12] Becht et al, supra note 2, 3115.
[13] Igor Filatotchev and Oksana Dotsenko, "Shareholder Activism in the UK: Types of Activists, Forms of Activism and their Impact on a Target's Performance" (2015) 19 Journal of Management and Governance 5, 16.
[14] See Section V.

levels of board monitoring.[15] The divergent results reached by the studies could be caused by the different features of their sample companies. Since the optimal level of board monitoring is highly firm-specific, institutional shareholder activism only improves board monitoring when it takes these factors into account. This raises two questions, what these factors are and whether institutional shareholders tailor their activism to specific companies. These will be explored in the next chapter.

2. Incentive Alignment

Institutional shareholder activism can improve incentive alignment in several ways. Institutional shareholders have opposed executive remuneration the amount of which cannot be justified by corporate performance and strengthened pay-performance sensitivity. They have also withheld support for reelections of remuneration committee members when they doubted the efficiency of executive remuneration.[16]

The previous chapter argued that the optimal level of incentive alignment varies for different companies and that excessive incentive alignment is costly and encourages managerial myopia.[17] Institutional shareholders can push companies' remuneration policies to be more tailored to their specific features. For example, innovation is highly risky.[18] If innovative companies link executive remuneration to short-term corporate performance, the high probability of failure might discourage managers from innovating. Innovation also takes a long time.[19] Rewards in the far future might not be enough to encourage innovation. Hence it might be more appropriate for innovative companies to develop other methods of incentive alignment, such as to pay managers when they advance innovation to another stage.[20] Support

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[15] See Chapter 3.
[16] See Chapter 5.
[17] See Chapter 3.
[18] Houman Shadab, "Innovation and Corporate Governance: The Impact of Sarbanes-Oxley' (2008) 10 University of Pennsylvania Journal of Business and Employment Law 955, 963.
[19] Ibid.
[20] David Balkin, Gideon Markman and Luis Gomez-Mejia, "Is CEO Pay in High Technology Firms Related to Innovation?" (2000) 43 Academy of Management Journal 1118, 1120.

from institutional shareholders would give companies more confidence to deviate from common practices of incentive alignment. Institutional shareholders can take the initiatives themselves if companies fail to optimize incentive alignment.

Institutional shareholders can also increase the efficiency of severance payments. Giving managers whose employments are terminated excessive severance payments reward failure[21] and reduce managers' incentives to maximize corporate value, which is why they are often called golden parachutes.[22] Severance payments might also act as takeover defences as the prospect of paying large severance payments after takeovers could discourage potential acquirers.[23] On the other hand, severance payments are the company's promises to managers that they would not be replaced as long as the benefits created by other candidates are smaller than the incumbents' severance payments.[24] Hence severance payments can make managers less risk-averse and encourage them to make firm-specific investments. For companies with higher levels of risk, making relatively large severance payments might be a cheaper way to increase managerial incentives than making large incentive payments. Institutional shareholders can ensure that companies have severance payments which fit their specific characteristics.

However, empirical studies on say-on-pay cast doubts on the efficiency of this type of institutional shareholder activism. In the US, Fisch *et al* found that although excessive compensation and compensation with high performance insensitivity were negatively linked to shareholder support, the actual amounts of pay weighed much more heavily in shareholder voting than the structure of the compensation.[25] More importantly, the results of say-on-pay were strongly-influenced by corporate performance. For instance, sample companies with the best performance received

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[21] Fabrizio Ferri and David Maber, "Say on Pay Votes and CEO Compensation: Evidence from the UK" (2013) 17 Review of Finance 527, 528.

[22] Pamela Hall and Dwight Anderson, "The Effect of Golden Parachutes on Shareholder Wealth and Takeover Probabilities" (1997) 24 Journal of Business, Finance and Accounting 445, 445.

[23] Ibid.

[24] Andres Almazan and Javier Suarez, "Entrenchment and Severance Pay in Optimal Governance Structures" (2003) 58 The Journal of Finance 519, 520.

[25] Jill Fisch, Darius Palia and Steven Davidoff Solomon, Is Say-on-Pay all about Pay? The Impact of Firm Performance, ECGI Working Paper No 374/2017, Accessed on September 16, 2019 at <https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=2933&context=faculty_scholarship>, at 22.

only 11.4% votes against excessive compensation. Companies with the poorest performance whose executive remuneration was not excessive had 20% negative votes.[26] The situation was similar in the UK. Gerner-Beuerle found that the results of say-on-pay were not affected by factors such as pay-performance sensitivity, retention period and circumstances for clawback.[27] The only factor that mattered in shareholder voting was the total amount of pay.[28] The studies showed that quite contrary to the hope that institutional shareholders would push companies to have more tailored incentive alignment, shareholder vote on executive remuneration quite blindly.

3. Market Discipline

The presence of institutional shareholders mitigates shareholder collective action problem in takeovers. Institutional shareholders generally consider themselves pivotal players and are less likely to free-ride in takeovers.[29] Institutional shareholders are also more capable to assess whether the offer is in the company's interests. Small shareholders who are aware of this are likely to follow the decisions of institutional shareholders. Hence the probabilities of success are increased for beneficial offers and decreased for detrimental offers, encouraging efficient takeovers.[30] Institutional shareholders also remove anti-takeover devices to reduce costs for acquirers. For example, Gillan and Starks studied over 2,000 shareholder proposals and found that most of them were relevant to the removal of anti-takeover devices.[31]

Hedge fund activism often breaks up companies. Smaller companies are more attractive takeover targets, as they are cheaper, more focused and can be more

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[26] Ibid, 23.
[27] Carsten Gerner-Beuerle and Tom Kirchmaier, Say on Pay: Do Shareholders Care? ECGI Finance Working Paper No 579/2018, Accessed on September 16, 2019 at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2720481>, at 7.
[28] Ibid, 20.
[29] Bengt Holmstrom and Barry Nalebuff, "To the Raider Goes the Surplus? A Reexamination of the Free-Rider Problem" (1992) 1 Journal of Economics and Management Strategy 37, 46.
[30] Wei Jiang, Tao Li and Danqing Mei, "Influencing Control: Jawboning in Risk Arbitrage" (2018) 73 Journal of Finance 2635, 2636.
[31] Stuart Gillan and Laura Starks, "Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors" (2000) 57 Journal of Financial Economics 275, 284.

smoothly combined with other business.[32] Sometimes hedge funds bid for target companies themselves, not because they want to take control of target companies, but to draw the attention of potential acquirers.[33] Therefore, acquiring companies could largely reduce search costs by focusing on targets of hedge fund activism. Sometimes hedge funds reach out to potential acquirers directly.[34] Normally, acquiring companies are suspicious of targets' offer solicitation, because they could have spent significant resources to make the offers while the targets are just using their bids to drive up offers from other bidders.[35] But hedge funds' offer solicitation is more trustworthy. Unlike the target which will cease being independent, hedge funds are repeat players. They value their reputation as brokers for takeovers and are unlikely to sacrifice future gains for profits from one transaction. In some cases hedge funds make commitments to acquirers of their choices, promising to sell their shares only to the bidder even when competing bids are made.[36] Nevertheless, hedge funds' active role in takeovers raises the question whether they would break up viable companies just to benefit from takeovers. This issue will be explored in the next chapter.

Empirical studies did find that targets of hedge fund activism were more likely to experience takeovers.[37] They also found positive market reaction to hedge fund activism on takeover-related issues. For example, Greenwood and Schor studied market reaction to hedge fund activism with different objectives and found that hedge fund activism to sell parts of the target has the largest positive abnormal returns.[38] Meanwhile, empirical studies found insignificant or negative market reaction to shareholder proposals to remove takeover defences.[39] Besides methodological

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[32] Adrian Corum and Doron Levit, Corporate Control Activism, Accessed on April 25, 2019 at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2600340>, 37.
[33] Nicole Boyson, Nickolay Gantchev and Anil Shivdasani, "Activism Mergers" (2017) 126 Journal of Financial Economics 54, 67.
[34] Ibid, 36.
[35] Charlie Weir, "The Market for Corporate Control" in Mike Wright, Donald Siegel, Kevin Keasey and Igor Filatotchev (eds), *The Oxford Handbook of Corporate Governance* (OUP 2013) 338.
[36] Ibid, 340.
[37] Boyson *et al*, supra note 33, at 55.
Robin Greenwood and Michael Schor, Hedge Fund Investor Activism and Takeovers, Accessed on April 25, 2019 at < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1003792>, 5.
[38] Greenwood and Schor, ibid, 11.
[39] Gillan and Starks, supra note 31, at 300.
Diane Del Guercio and Jennifer Hawkins, "The Motivation and Impact of Pension Fund Activism"

limitations, one explanation for these results is that the studies did not take firm-specific factors into consideration. Companies with high probabilities of takeovers would want to have some takeover defences to drive up offers. Companies which do not expect takeovers in the near future are more likely to welcome the removal of takeover defences to benefit from the governance of the market for corporate control.[40] Companies with long-term projects might wish to be insulated from the short-term pressure of the market for corporate control. Therefore whether institutional shareholder activism to encourage takeovers is really beneficial depends on whether it fits companies' specific circumstances.

4. Hedge Fund Activism as an Independent Governance Mechanism

Institutional shareholder activism can act as an independent governance mechanism which fills the gaps in the corporate governance system. The agency problem is first controlled internally by board monitoring and incentive alignment. A strongly efficient market would promptly reflect the company's remaining agency costs in the share price, which might drive the board to improve the effectiveness of internal corporate governance. In the case of the board's failure to act, the company's share price would be further discounted until to a point where the market for corporate control is invoked as a governance mechanism of last resort.[41] Since the market is imperfectly efficient, a company's share price is only able to reflect the agency problem when it is quite serious. Thus a governance gap exists where the company has some level of agency costs which are not large enough to depress price. Hostile takeovers discipline by changing control of target companies. The high costs to do so leave many companies undisciplined and another gap in the corporate governance system.

Institutional shareholder activism, mostly hedge fund activism, fills these gaps.

(1999) 52 Journal of Financial Economics 293, 325.

[40] Frank Easterbrook and Daniel Fischel, "The Proper Role of a Target's Management in Responding to a Tender Offer" (1981) 94 Harvard Law Review 1161, 1177.

[41] Michael Jensen, The Takeover Controversy: Analysis and Evidence, Accessed on April 25, 2019 at < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=173452>, 9.

To search for potential targets, hedge funds conduct deep analysis on a large number of companies. Securities analysts who are major market formers also perform this task. But they might refrain from issuing negative opinions on a company to keep being in the management's favor, which gives them access to valuable information.[42] Hedge funds do not have such concerns and are likely to act on problematic companies before their problems are reflected in the share price. Addressing problems at an earlier stage also means that they would do less harm to the company and can be fixed more easily, filling the first gap in corporate governance. Moreover, hedge funds engage in activism by purchasing minority shareholdings. Compared to the market for corporate control, the market of hedge fund activism is characterized as a market for corporate influence,[43] which is not only cheaper, but also less risky. Hence hedge fund activism is able to discipline companies which are left unaddressed by the market for corporate control, filling the second gap in corporate governance.

II. Self-Interested Activism

1. Overview

Sometimes institutional shareholders derive benefits from shareholder activism which are not shared by other members of the company. When their private benefits outweigh the sum of activism costs and losses they suffer as shareholders, institutional shareholders have incentive to engage in self-interested activism, which is often detrimental to the company.

Consider the hypothetical case where an institutional investor holds shares in both a manufacturing company and its supplier, but its position in the manufacturer is much larger. The institutional investor then pushes the supplier to supply the

[42] John Coffee, Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms, Columbia Law and Economics Working Paper No 237, Accessed on September 16, 2019 at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=447940>, at 20.
[43] Brian Cheffins and John Armour, The Rise and Fall (?) of Shareholder Activism by Hedge Funds, ECGI Law Working Paper No 136/2009, Accessed on September 16, 2019 at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1489336>, 5.

manufacturer at a discount. That enables the manufacturer to produce at low costs and to increase sales, but it reduces the supplier's profits. The activism makes profits for the institutional investor because its gains from the manufacturer outweigh its losses in the supplier. But it is against the interests of other shareholders in the supplier.[44] This type of self-interested activism is more likely to be a problem of hedge fund activism than activism of other institutional shareholders. Mainstream institutional investors are widely diversified.[45] At first it seems to suggest that mainstream institutional investors have more opportunities to increase the value of one investee company at the expense of another. However, mainstream institutional investors seldom have large shareholdings.[46] Hence benefits from one company are unlikely to outweigh the sum of activism costs and losses in the other company. Meanwhile, hedge funds are willing to hold large positions[47] and might find self-interested activism appealing.

Different types of institutional investors have different private benefits from shareholder activism. Corporate pension funds often invest in their sponsoring companies. Sometimes they have incentives to engage in activism for the benefits of employees. This is especially the case when unions participate in the management of the funds. Matsusaka *et al* found that union-controlled pension funds submitted 20% more shareholder proposals when unions and companies renegotiated collective labor contracts than in other years.[48] A closer look at the proposals showed that in renegotiation years more proposals were made on issues which affect managers directly, such as executive remuneration and director elections.[49] It appeared that union-controlled pension funds engaged in shareholder activism to increase their bargaining power in negotiation with managers over collective labor contracts. The technique was mostly effective, as the researchers found that employee salaries were

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[44] Edward Rock, "Controlling the Dark Side of Relational Investing" (1994) 15 Carbozo Law Review 987, 996.
[45] See Chapter 1.
[46] Ibid.
[47] Ibid.
[48] John Matsusaka, Oguzhan Ozbas and Irene Yi, Opportunistic Proposals by Union Shareholders, USC CLASS Research Paper No CLASS 15-25, <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2666064>, 2.
[49] Ibid, 3.

higher in companies where union-controlled pension funds withdrew their proposals than in other companies.[50]

Public pension funds receive funding from local authorities and could be pressurized into activism which furthers the benefits of local communities, rather than shareholders.[51] For example, public pension funds might push the company to build a factory in the local area to increase the region's employment rate, although labour would be cheaper in other places. Some trustees of public pension funds are politicians. Hence they might cause the funds to engage in activism for the advancement of their own political careers.[52] For instance, a public pension fund might oppose a profitable project because it is viewed negatively by the trustees' target voters.

Hedge funds are free to trade securities derivatives which could make their interests different from the interests of other shareholderS. Short selling is a type of trading where an investor borrows and sells a company's shares with the obligation to return them later.[53] Put options give holders rights to sell a pre-specified amount of shares at a certain price in a certain period of time once the strike price is met.[54] Hence investors holding short positions and put options are betting that the company's share price will drop.[55] When profits from their short positions outweigh the losses from long positions, hedge funds have incentives to depress the company's share price by activism.

In the meantime, once the strike price is met, holders of call options have rights to purchase certain amounts shares in a certain period at a specific price. Hence holders of call options are betting the company's share price to rise.[56] But compared to ordinary shareholders, their call options mean that hedge funds have much more to

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[50] Ibid, 13.
[51] Roberta Romano, "Public Pension Fund Activism in Corporate Governance Reconsidered" (1993) 93 Columbia Law Review 795, 804.
[52] Ibid, 822.
[53] David Stowell, *An Introduction to Investment Banks, Hedge Funds and Private Equity* (Elsevier 2010) 102.
[54] Shaun Martin and Frank Partnoy, "Encumbered Shares" (2005) University of Illinois Law Review 775, 789.
[55] Stowell, supra note 53, 102.
[56] Martin and Partnoy, supra note 54, 790.

gain from the company's increased share price. Thus hedge funds could push for strategies which are far beyond the risk preference of ordinary shareholders to increase the company's share price.

The fact that hedge funds hold various securities derivatives concerning different portfolio companies exacerbates the problem. In 2004, Deustche Borse made a hostile offer for London Stock Exchange. The acquisition was opposed by the Children's Investment Fund, a hedge fund based in London. TCI argued that the offer overvalued the LSE and that the combination of the two entities was unlikely to be allowed by competition authorities.[57] Meanwhile the board of DB claimed that TCI's arguments were ill-founded.[58] At the time there were rumors that TCI held short positions in the LSE.[59] In takeovers, share prices of target companies usually rise due to the prospect of takeover premiums.[60] Share prices of acquiring companies often drop, because business combination is complicated, takes a long time and does not often succeed.[61] If TCI really held short positions in the LSE, it would suffer considerable losses from the acquisition. Hence from this perspective alone, it was reasonable to doubt TCI's motive behind the activism. However, TCI's campaign was joined by other institutional shareholders, including Fidelity, one of the biggest mutual funds in the US and the investment management branch of Merrill Lynch. As other institutional shareholders were unlikely to share TCI's private interests, their support was most likely to be based on the merits of the case, which significantly strengthened the case in TCI's favour. In the end, the acquisition was terminated. Activist shareholders also succeeded in removing the chairman of the supervisory committee.[62]

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[57] Sudi Sudarsanam and Tim Broadhurst, "Corporate Governance Convergence in Germany through Shareholder Activism: Impact of the Deutsche Borse Bid for London Stock Exchange" (2012) 16 Journal of Management and Governance 235, 252.
[58] Ibid, 251.
[59] The Guardian, The Long and Short of LSE Bid Collapse (March 13, 2005).
[60] Jiang et al, supra note 30, 2640.
[61] Ibid, 2660.
[62] Sudarsanam and Broadhurst, supra note 57, 253.

2. Third Party Payments

As hedge funds often succeed in having directors of their choosing on the board, it raises the concern that these directors might pursue hedge funds' private agenda. A casual review of activism cases shows that most directors were well aware that even when they were appointed by specific shareholders, they had duties to the company and shareholders as a whole. For example, in 2008 Microsoft made an offer to Yahoo's board to acquire the company's controlling shares. The board refused to recommend the offer to shareholders. Icahn Enterprise, as shareholder of Yahoo, was in favour of the offer and engaged in activism to push the deal. It succeeded in appointing two directors to the board. But the two directors decided that Microsoft's offer was not beneficial to the company and resisted Icahn's further activism. Eventually, Icahn exited Yahoo with losses.[63]

However, the emergence of third party payments undermines the credibility of directors appointed by hedge funds. Third party payment refers to director remuneration awarded by parties other than the company.[64] They played a significant role in Jana's activism in Agrium. Agrium was a Canadian company producing fertilizers. It also had divisions for retail and wholesale. Jana Partners, an American hedge fund, suggested a spinoff of Agrium's retail division.[65] The company refused and Jana initiated a proxy fight to replace five directors.[66] The credibility of Jana's nominees was undermined as it was revealed that they had agreements with Jana, according to which Jana would pay them a percentage of its profits if it could make a profitable exit within three years. Jana terminated the proxy fight after the payments were made public.[67]

Third party payments do have their merits. In a proxy fight, incumbent directors

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[63] Owen Walker, *Barbarians in the Boardroom: Actvist Investors and the Battle for Control of the World's most Powerful Companies* (Pearson, 2016) 77.
[64] Edward Iacobucci, "Special Compensation Arrangements for Dissident Directors in Proxy Contests: A Policy Analysis" (2014) 55 Canadian Business Law Journal 365.
[65] Jana Partners, Unlocking Agrium's True Value Potential, Accessed on April 27, 2019 at <https://www.businessinsider.com/jana-partners-agrium-presentation-2012-10?r=US&IR=T#-1>, 12.
[66] Ibid, 32.
[67] John Coffee, Are Shareholder Bonuses Incentives or Bribes? Reuters (April 26, 2013).

and dissident nominees have to spend considerable time traveling around and meeting with shareholders. Incumbent directors' expenses for doing so are covered by the company while dissident nominees are only reimbursed if they are elected to the board.[68] By paying their director nominees, hedge funds can attract more talented directors and induce them to put more efforts into proxy fights. Third party payments can also act as positive signals. In a proxy fight, dissident nominees not only need to prove that incumbent directors are incompetent, but also that they are superior to incumbent directors.[69] One way to signal directorial qualities is to purchase the company's shares. But proxy fights usually drive up the company's share price, making that signal expensive. Accepting third party payments with performance targets can be much cheaper signals.[70]

Nevertheless, the potential harm of third party payments is likely to be much more significant. As the case of Agrium showed, hedge funds not only pay directors for participating in proxy fights, but also for reaching activism objectives. Hence instead of evaluating hedge funds' proposals in accordance with their duties to the company, recipient directors would simply push for hedge funds' objectives. Third party payments with short time frames also encourage recipient directors to be short-term focused. As third party payments make recipient directors dependent on hedge funds, they are often called golden leashes.[71] It is not to say that all activist shareholders who make third party payments are self-interested or myopic. But third party payments certainly create more opportunities for detrimental shareholder activism. Thus this thesis argues that third payment payments should be prohibited, especially since most benefits of third party payments could be replicated. For example, companies who value the ability to attract more talented directors can reimburse unsuccessful dissident nominees for their expenses incurred in proxy fights. In the UK, section 176 of the Companies Act 2006 imposes a duty on directors not to accept third party payments. There is no equivalent provision in the US. Companies in

[68] Lucian Bebchuk, "The Myth of the Shareholder Franchise" (2007) 93 Virginia Law Review 675, 690.
[69] Ibid, 693.
[70] Iacobucci, supra note 64, 373.
[71] Ibid, 376.

the US used to respond to golden leashes by adopting director disqualification bylaws, which render director nominees who receive third party payments unqualified to stand for election.[72] But in 2013, the ISS recommended shareholders to withhold support for the directors of Provident, a company with director disqualification bylaw. As 34% of votes were withheld that year, Provident repealed the bylaw. Afterwards most director disqualification bylaws were repealed.[73] The ISS's objection against the director disqualification bylaw was mostly likely to be based on the board's ability to unilaterally adopt bylaws which impede shareholder activism. But its position encouraged the usage of third party payments. In 2014, Third Point nominated two directors to the board of Dow Chemical. Third Point agreed to pay the directors $250,000 for being nominated and another $250,000 if they were elected. Further payments would be made based on the company's performance in three to five years. Presumably because the payments suggested that the activism was not short-term focused, the ISS cautiously supported the activism.[74] This led the company to appoint the two directors.[75] Third Point's payment arrangements were the first ever implemented third party payments, the success of which encouraged more similar payments. NASDAQ responded to the growth of third party payments by amending its listing rules to require directors and director nominees to disclose any payments made or will be made by parties other than the company. The previous rule did not apply to director nominees or unpaid remuneration.[76] But the amendment failed to control the usage of third party payments. Hence this chapter argues that the US

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[72] Carl Icahn, Disqualifying Dissident Nominees: A New Trend in Incumbent Director Entrenchment, Harvard Law School Forum on Corporate Governance and Financial Regulation, Accessed on April 27, 2019 at <https://corpgov.law.harvard.edu/2014/02/12/disqualifying-dissident-nominees-a-new-trend-in-incumbent-director-entrenchment/>

[73] Matthew Cain, Jill Fisch, Sean Griffith and Steven Solomon, "How Corporate Governance is Made: The Case of The Golden Leash" (2016) 164 University of Pennsylvania Law Review 649, 673

[74] Anna Christie, "The New Hedge Fund Activism: Activist Directors and the Market for Corporate Quasi-Control" (2019) 19 Journal of Corporate Law Studies 1, 32

[75] Sayantani Ghosh and Kanika Sikka, Dow Chemical, Dan Loeb Settle Board Debated, Reuters, (November 21, 2014)

[76] Colin Diamond, David Johansen, Irina Yevmenenko, An Analysis of Nasdaq's Golden Leash Disclosure Rule, Accessed on April 27, 2019 at <https://www.whitecase.com/publications/alert/analysis-nasdaqs-golden-leash-disclosure-rule>.

should adopt the UK approach by having a statutory ban on third party payments.

3. Summary

With third party payments out of the picture, the problem of self-interested activism can be mitigated. Previously, minority shareholders could succeed in self-interested activism because shareholder activism was rare. Managers were willing to accede to the demands of activist shareholders or to purchase their shares at above market price to make them go away. This practice, commonly known as greenmail,[77] is no longer effective. Currently there are a large number of activist hedge funds in the market. Managers understand that paying one off does not prevent another from activism.[78] In fact, it signals managerial weakness and might even attract more activism. As most activist shareholders hold minority stakes, they can only succeed by securing support of other institutional shareholders. Different institutional shareholders have different private interests. Hence if institutional shareholders cast informed votes on shareholder activism, their votes are most likely to be based on the merits of the activism. There is the possibility of collusion between institutional shareholders. One institutional shareholder might be able to secure another's support by promising to support it in other companies or to compensate its losses in other ways. To mitigate this problem, institutional investors should publicize and explain their votes on shareholder activism. This point will be explored further in Chapter 7.

III. Short-Termist Activism

Corporate finance theory advocates that money in the present is more valuable than the same amount of money in the future.[79] Consider the hypothetical case where

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[77] Lucian Bebchuk, "The Case for Increasing Shareholder Power" (2005) 118 Harvard Law Review 833, 885

[78] Ibid

[79] Stephen Ross, Randolph Westerfield and Jeffrey Jaffe, *Corporate Finance* (5th edn, McGraw-Hill,

an investor is presented with two investment options. The first option yields £1000 straight away while the second makes £1100 one year later. Suppose bank interest rate is 8% per annum. If the investor has no use of the money other than depositing it in the bank, she would have £1080 at the end of the year. As it is smaller than the yield of the second option, she should choose the second option. But if she has more profitable use of the money, she should choose option one. Hence it is reasonable of investors to discount earnings in the long term. But sometimes investors discount long-term earnings much more than their time value. Some studies found that investor myopia is more prevalent in the US and the UK than in other countries. For example, Black and Fraser found that in the UK, market valuation of earnings made in 5 years only reflected 13.2% of their rational valuation whereas in Japan, market valuation represented 96% of the earnings' value.[80] But it is incorrect to characterize the market as myopic. Indeed stock market bubbles were often caused by investors' excessive overvaluation of the long term.[81] Hence it is safest to say that the market is imperfectly efficient and is sometimes short-term biased.

Investors can transmit myopia to managers by linking executive remuneration to short-term corporate performance.[82] The combination of investor myopia and active takeover markets also leads to managerial myopia.[83] When investors discount the value of long-term focused companies, managers who are keen to avoid hostile takeovers have incentives to raise the company's share price by sacrificing its long-term value for the short term, such as by cutting R&D expenditure to strengthen the company's cash flow..

Managers might feel the need to show improved performance in each disclosure and a frequent disclosure regime could encourage managerial myopia.[84] In the US where a quarterly disclosure regime is in place, it has long been debated whether a

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1999) 52.

[80] Angela Black and Patricia Fraser, "Stock Market Short-Termism: An International Perspective" (2002) 12 Journal of Multinational Financial Management 135, 143.

[81] Michael Jensen, "Agency Costs of Overvalued Equity" (2005) 34 Financial Management 5, 6.

[82] Mark Roe, "Corporate Short-Termism: In the Boardroom and in the Courtroom" (2013) 68 Business Lawyer 977, 985.

[83] Ibid.

[84] Marc Moore and Edward Walker-Arnott, "A Fresh Look at Stock Market Short-Termism" (2014) 41 Journal of Law and Society 416, 427.

UK style interim disclosure system should be adopted to mitigate managerial myopia.[85] Some empirical studies have found that disclosure frequency alone did not cause managerial myopia, but its combination with market pressure did. For example, Bhojraj and Libby found that when managers were subject to market pressure, such as when their companies needed to issue new shares, a quarterly disclosure rule indeed induced more myopia than a semi-annual disclosure rule. But when managers did not face market pressure, disclosure frequency had no effect on managerial behavior.[86]

Hence some researchers proposed that in order to mitigate managerial myopia, managers should be insulated from short-term market pressure. For example, Lipton and Rosenblum proposed that directors should be elected every five years. During its term the board should have absolute control on takeovers.[87] However, most empirical studies failed to find a positive correlation between managerial entrenchment and long-term corporate value. For example, Gompers *et al* constructed a Governance Index using 24 takeovers defences.[88] They found that companies which ranked higher in the index (companies with more entrenched managers) had lower corporate value in the long term.[89] Bebchuk *et al* argued that out of the 24 factors, only six affected corporate value and constructed an Entrenchment Index using the six factors.[90] They also found that higher ranking companies had lower value.[91] The studies suggest that the costs of managerial entrenchment, namely increased agency costs, are likely to outweigh the benefits.

Institutional shareholder activism can both exacerbate and mitigate managerial myopia. On one hand, myopic activist shareholders can push through strategies which create short-term profits at the expense of long-term corporate value, such as by

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[85] Arthur Kraft, Rahul Vashishtha and Mohan Venkatachalam, "Frequent Financial Reporting and Managerial Myopia" (2018) 93 The Accounting Review 249, 252.
[86] Sanjeev Bhojraj and Robert Libby, "Capital Market Pressure, Disclosure Frequency-Induced Earnings/Cash Flow Conflict and Managerial Myopia" (2005) 80 The Accounting Review 1, 17.
[87] Martin Lipton and Steven Rosenblum, "A New System of Corporate Governance: The Quinquennial Election of Directors' (1991) 58 The University of Chicago Law Review 187, 225.
[88] Paul Gompers, Joy Ishii and Andrew Metrick, "Corporate Governance and Equity Prices" (2003) 118 The Quarterly Journal of Economics 107, 115.
[89] Ibid, 127.
[90] Lucian Bebchuk, Alma Cohen and Allen Ferell, "What Matters in Corporate Governance" (2009) 22 The Review of Financial Studies 783, 785.
[91] Ibid, 805.

requesting special dividends paid out of R&D expenditure or proceeds from selling important divisions. Previously managers only need to resort to short-termism to avoid hostile takeovers when the company is severely underperforming. As shareholder activism could target well-performing companies, shareholder activism would subject managers to continuous myopic pressure. On the other hand, institutional shareholders have more expertise than retail investors to look beyond the company's current performance and focus on its long-term value. As retail investors are likely to copy the transactions of institutional investors, investor myopia can be mitigated. Managers can reach out to institutional shareholders and explain their long-term strategies. The support of institutional shareholders would prevent managerial myopia out of the misperception of investor myopia.[92]

Therefore, the important issue is whether institutional shareholders have incentives to engage with companies to promote long-term value or to extract short-term value to the detriment of the long term. Mutual funds and insurance companies compete for clients based on their performance in the past year or the past quarter.[93] Pension funds do not face intensive competition, but their fund managers do. Research has shown that past short-term performance is one of the most important factors in the selection of fund managers.[94] Thus mainstream institutional investors have incentives to be myopic. As they do not have incentives to initiate shareholder activism, their myopia is likely to manifest in exiting underperforming companies and in supporting myopic activism. Remuneration of hedge fund managers is heavily performance-based, which gives them strong incentives to engage in myopic activism to improve the funds' performance.

A large volume of empirical studies have been conducted to examine the effect of institutional shareholder activism on long-term corporate value. With regards to mainstream institutional investors, most studies examined the relationship between institutional share ownership and corporate value and reached mixed results. For

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[92] Geof Stapledon, *Institutional Shareholders and Corporate Governance* (OUP, 1996) 212.
[93] Ibid, 221.
[94] Tim Jenkinson, Howard Jones and Jose Vicente Martinez, "Picking Winners? Investment Consultants' Recommendations of Fund Managers" (2016) 71 The Journal of Finance 2333, 2344.

example, Clay found that 1% increase in institutional share ownership led to 0.75% increase in Tobin's Q.[95] Empirical studies on corporate long-term value after hedge fund activism generally found positive results. For example, Boyson and Mooradian found that target companies' Tobin's Q increased by 0.21 one year after hedge fund activism.[96] Brav *et al* found that on average target companies made 8.4% above market returns one year after hedge fund activism.[97] The results were not reversed two years after activism.[98] Bebchuk *et al* documented positive abnormal returns of 5.81% five years after hedge fund activism.[99]

Some studies specifically examined the effect of institutional shareholder activism on companies' R&D expenditures. The results were inconclusive. For example, with regards to mainstream institutional shareholders, Wahal and McConnell found that companies' R&D expenditures were positively correlated to institutional share ownership.[100] Bushee categorized institutional investors into three groups. Transient investors were widely diversified and had high turnover rates. Quasi-indexers were widely diversified and had low turnover rates. Dedicated investors had concentrated share ownership and low turnover rates.[101] He found that increased ownership by transient investors led to decrease in R&D expenditures. But increased ownership by quasi-indexers and dedicated investors did not result in increased R&D expenditures.[102] Most studies on hedge fund activism's effect on R&D expenditure reached negative results. For instance, Brav *et al* and Bebchuk *et al* all found reductions in R&D expenditures after hedge fund activism.[103] However,

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[95] Darin Clay, Institutional Ownership and Corporate Value, Accessed on April 27, 2019 at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=485922>, 11.
[96] Nicole Boyson and Robert Mooradian, "Corporate Governance and Hedge Fund Activism" (2011) 14 Review of Derivatives Research 169, 189.
[97] Alon Brav, Wei Jiang, Frank Partnoy and Randall Thomas, "Hedge Fund Activism, Corporate Governance and Firm Performance" (2008) 68 The Journal of Finance 1729, 1756.
[98] Ibid, 1771.
[99] Lucian Bebchuk, Alon Brav and Wei Jiang, "The Long-Term Effects of Hedge Fund Activism" (2015) 115 Columbia Law Review 1085, 1126.
[100] Sunil Wahal and John McConnell, "Do Institutional Investors Exacerbate Managerial Myopia?" (2000) 6 Journal of Corporate Finance 307, 319.
[101] Brian Bushee, "The Influence of Institutional Investors on Myopic R&D Investment Behavior" (1998) 73 The Accounting Review 305, 327.
[102] Ibid, 309.
[103] Alon Brav, Wei Jiang, Song Ma and Xuan Tian, "How does Hedge Fund Activism Reshape Corporate Innovation" (2018) 130 Journal of Financial Economics 237, 244.

large R&D expenditures do not necessarily translate into long-term investments. Companies' capital expenditure should match their growth opportunities. Companies with few growth opportunities might only invest in R&D to create impressions of growth. Indeed, Zhu found that hedge fund targets had fewer growth opportunities than their peers, but had the same level of R&D expenditures before activism. Thus he argued that hedge fund activism which reduced R&D expenditures was beneficial as it mitigated the overinvestment problem.[104] Brav *et al* also studied hedge fund activism's effect on companies' R&D output. They found that target companies had more patent approvals and more patent citations after hedge fund activism.[105] Thus they concluded that hedge fund activism did not reduce companies' innovative capacities. However, there usually is a time lag between actual innovation and the granting of patents[106] and the real effect of hedge fund activism might not have been captured by the study.

IV. Negative Externalities

Shareholder activism not only affects target companies and their shareholders, but also imposes costs and benefits on other stakeholders and non-targeted companies. The externalities of institutional shareholder activism are negative if the costs outweigh the benefits.

1. Creditors

Hedge fund activism, such as activism to reduce cash reserves and to divest, increases companies' insolvency risks and could be prejudicial to creditors. But it could also be beneficial to creditors. The previous chapter argued that there are two

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Bebchuk *et al*, supra note 99, 1136.

[104] Heqing Zhu, The Preventive Effect of Hedge Fund Activism, Accessed on April 26, 2019 at <https://ssrn.com/abstract=2369533>, 22.

[105] Brav *et al*, supra note 103, 12-13.

[106] Shiferaw Gurmu and Fidel Perez-Sebastian, Patents, R&D and Lag Effects: Evidence from Flexible Methods for Count Patent Data on Manufacturing Firms, Accessed on April 27, 2019 at <http://www2.gsu.edu/~ecosgg/research/pdf/gp_ee.pdf>, 4.

types of creditors, those who can renegotiate their contracts with the company and creditors those are subject to the company's power. Adjustable creditors have a corporate governance function. Creditors, such as banks which also execute transactions for debtor companies, have information to monitor debtor companies and can request higher interest rates to reflect their increased risks. Creditors that do not have access to private information can subject debtor companies to loan covenants, which usually restrict debtor companies' risk-taking and set triggers for acceleration of debt repayments.[107] Both approaches control agency costs. Financial innovation allows loans to be collectivized, securitized and publicly traded.[108] This not only reduces creditors' incentives in corporate governance, but also decreases their willingness to extend payments for debtor companies, increasing their probabilities of insolvency.[109] Hedge fund activism can make up for decreased debt governance. Improved governance and decreased insolvency risks should benefit non-adjustable creditors the most. Empirical studies found some support for this argument. For example, Sunder *et al* found that creditors reacted negatively to hedge fund activism which increased target companies' risk levels, such as activism concerning corporate control and capital expenditure. But creditors reacted positively to hedge fund activism which reduced managerial entrenchment.[110] Thus whether hedge fund activism is beneficial or detrimental to creditors depends largely on its efficiency to the company.

2. Peer Companies

Institutional shareholder activism affects non-target companies. R&D has a spillover effect. Coffee and Palia believe that once a company introduces a new

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[107] Charles Whitehead, Creditors and Debt Governance, Accessed on April 27, 2019 at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1760488>, 3.
[108] Lynne Dallas, "Short-Termism, the Financial Crisis and Corporate Governance" (2011) 37 Journal of Corporation Law 264, 284.
[109] Whitehead, supra note 107, 14.
[110] Jayanthi Sunder, Shyam Sunder and Wan Wongsunwai, "Debtholder Responses to Shareholder Activism: Evidence from Hedge Fund Interventions" (2014) 27 The Review of Financial Studies 3318, 3321.

product, others companies learn from and improve the product. Several rounds of upgrades often result in a completely different product.[111] This view is supported by empirical studies. For example, Griliches *et al* found a positive correlation between a company's R&D expenditure and the performance of other high R&D companies in the same industry. The correlation was negative for low R&D companies.[112] This innovation cycle cannot function properly if myopic shareholder activism cut companies' R&D expenditures.

When shareholder activism improves the performance of target companies, their competitors would be subject to more competitive pressure, which would incentivize their managers to reduce agency costs voluntarily. Shareholder activism at one company might also motivate managers of other companies to make their companies less attractive to activist shareholders. The spillover effect would be detrimental if the threat of shareholder activism makes managers reduce essential R&D expenditure or cash reserves. However the spillover effect could also be positive if it prompts managers to control agency costs voluntarily. Martin Lipton, a renowned corporate lawyer, suggested his clients to take several steps to fend off activist shareholders, many of which are good corporate governance practices. For example, it is suggested that the board should be informed, have constant communications with major institutional shareholders and explain any performance failures.[113] Gantchev *et al* found that peer companies which adopted practices advocated by hedge funds had improved performance two years after activism.[114] Thus the effect of hedge fund activism on non-target companies depends largely on its efficiency to target companies.

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[111] John Coffee and Darius Palia, "The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance" (2016) 42 Journal of Corporation Law 1, 8.

[112] Zui Griliches, Ariel Pakes and Bronwyn Hall, The Value of Patents as Indications of Inventive Activity, NBER Working Paper No 2083, Accessed on April 27, 2019 at <https://www.nber.org/papers/w2083>, 23.

[113] Martin Lipton, Dealing with Activist Hedge Funds and other Activist Investors, Harvard Law School Forum on Corporate Governance and Financial Regulation, Accessed on April 27, 2019 at <https://corpgov.law.harvard.edu/2017/01/26/dealing-with-activist-hedge-funds-and-other-activist-investors/>.

[114] Nicolay Gantchev, Oleg Gredil and Chotibhak Jotikasthira, Governance under the Gun: Spillover Effects of Hedge Fund Activism, ECGI Finance Working Paper No 562/2018, Accessed on April 27, 2019 at < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2356544>, 23.

V. Limitations of Empirical Studies

Generally empirical studies on the effect of institutional shareholder activism can be categorized into three groups. This first group investigated the relationship between institutional share ownership and corporate value. The main limitation with this type of studies is reverse causality, that instead of increasing corporate value, institutional investors might simply invest in companies with high value.[115]

The second type of empirical studies examined the effect of shareholder proposals on companies, mostly submitted by public pension funds. Two limitations are associated with these studies. First, to study the short-term effect of shareholder activism, pinpointing the date on which shareholder activism occurred is important. Public pension funds, such as CalPERS, publish their target lists each year.[116] Some studies took the publication date as the activism date.[117] But CalPERS does not engage with all companies included in the lists. Some companies had been targeted more than once.[118] Hence market reaction to the publication of the target lists might be distorted by the probabilities of actual activism. Some studies chose the proxy mailing date as the activism date.[119] But other information contained in the proxy statements is likely to distort the results. Probabilities of passing the proposals and their implementation are also likely to distort the results.[120]

Second, the market's reaction might be influenced by the signaling effect of shareholder proposals. Most mainstream institutional shareholders engage in activism by first having private negotiations with managers. It is widely believed that shareholder proposals are only submitted when negotiations fail, which indicates managers; entrenchment and their non-responsiveness to shareholder voice. Thus the

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[115] Kee Chung and Hao Zhang, "Corporate Governance and Institutional Ownership" (2011) 46 The Journal of Financial and Quantitative Analysis 247, 249.
[116] James Nelson, "The CalPERS Effect Revised Again" (2006) 12 Journal of Corporate Finance 187, 188.
[117] Del Guercio and Hawkins, supra note 39, 319.
[118] James Nelson, "Does Good Corporate Governance Really Work? More Evidence from CalPERS" (2005) 6 Journal of Asset Management 274, 277.
[119] Andrew Prevost and Ramesh Rao, "Of What Value Are Shareholder Proposals Sponsored by Public Pension Funds" (2000) 73 The Journal of Business 177, 186.
[120] Stuart Gillian and Laura Starks, "The Evolution of Shareholder Activism in the United States" (2007) 19 Journal of Applied Finance 55, 65.

market's reaction to shareholder proposals might not be based on their efficiency, but on the signal they send.[121] This argument is not without flaws. For example, according to the signal theory, a company which has been repeatedly targeted by activist shareholders would signal severe agency problems. But studies did not always find negative market reactions to such activism.[122] Nevertheless, the signal problem affects the robustness of the studies.

The third type of empirical studies examine the market reaction to the announcement of hedge fund activism. The date and signal problem are not serious concerns for studies of hedge fund activism. Hedge funds whose share ownership exceeds 5% of the company's shares must publicly disclose their ownership and their intentions for purchasing the shares.[123] Thus activism date is usually the date of ownership disclosure. Moreover, hedge fund activism typically starts with confrontational measures and does not signal managerial responsiveness.

The main challenge faced by studies on hedge fund activism is also causation. A common issue faced by researchers is how to make sure that hedge funds really caused operation or performance changes, instead of simply investing in companies which were about to have these changes even without activism. Most researchers addressed this problem by focusing only on hostile activism. The rationale is that companies which resisted hedge fund activism would not adopt the changes it advocated voluntarily or experience performance improvement absent hedge fund activism.[124] However, companies which are unresponsive to shareholder demands are often companies with high agency costs. Hedge fund activism at these companies is more likely to be beneficial but also needs more time to have effect. Studies focusing only on these companies might overestimate the overall benefits of hedge fund activism. Meanwhile, using this approach, studies which measure post-activism corporate value in a relatively short period are more likely to underestimate the

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[121] Ibid.
[122] Philip English, Thomas Smythe and Chris McNeil, "The CalPERS Effect Revisited" (2004) 10 Journal of Corporate Finance 157, 168.
[123] 17 C.F.R. § 240.13d.
[124] Alon Brav, Wei Jiang, Frank Partnoy and Randall Thomas, "Hedge Fund Activism, Corporate Governance and Firm Performance" (2008) 68 Journal of Finance 1729, 1764.

benefits of hedge fund activism.

Another problem with causation is how to ensure that the changes were caused by hedge fund activism, not other external factors. To address this problem, most researchers compared the performance of target companies and control companies, often matched by size, industry and past performance.[125] But there is always the possibility that some important factors are left out in the matching process. In fact, if researchers managed to construct a perfectly matched control group, then the question raised would be why the control companies were not targeted in the first place.[126] Moreover, control companies might experience spillover effect. Comparing the two groups' performance could underestimate either the benefits or the costs of hedge fund activism.

Even if the empirical studies were flawless individually, their discrepancy means that they cannot be collectivized into a piece of strong evidence supporting hedge fund activism. First, most studies define long term differently. For example, Klein and Zur examined target companies' stock performance one year after the announcement of activism.[127] This period is likely to be too short even for activism to be concluded. In contrast, Bebchuk *et al* examined target companies' stock performance five years after activism.[128] Although five years is definitely a long term period, many events had happened in this period, making establishing causation particularly difficult.

More importantly, although most studies agreed that hedge fund activism creates long-term corporate value, they could not agree on how value was created. Many empirical studies examined whether value was created from improved operating performance and reached different conclusions. For example, Boyson and Mooradian found that one year after hedge activism, ROA[129] of target companies was improved by 6%.[130] Meanwhile, Klein and Zur found that ROA was 2.4% lower.[131] One

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[125] Boyson and Mooradian, supra note 96, 180.
[126] Gillian and Starks, supra note 120, 67.
[127] April Klein and Emanuel Zur. "Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors" (2009) 64 Journal of Finance 187, 220.
[128] Bebchuk *et al,* supra note 99, 1103.
[129] Return on Assets.
[130] Boyson and Mooradian, supra note 96, 185.
[131] Klein and Zur, supra note 127, 223.

explanation for this inconclusiveness lies exactly in their focus on ROA. Increased ROA is not an accurate proxy for improved operating performance, as this ratio can be increased if earnings are reduced but there is even larger reduction in assets.[132]

Finally, shareholder activism is a real life phenomenon. Empirical studies on shareholder activism alone can never be convincing enough as they are cut from evidence and experience in the real world.[133]

VI. Conclusion

This chapter examined the benefits and costs of shareholder activism in general and reviews empirical studies on the efficiency of shareholder activism. The benefits lie in its improvement to corporate governance while the costs are probabilities of self-interested activism, myopic activism and negative externalities. In the course of discussion it was revealed that the beneficial and detrimental effect of institutional shareholder activism varies for companies with different characteristics. Theoretical and empirical studies on shareholder activism is also limited as they are detached from shareholder activism in the real world. The next chapter fills these gaps by conducting case studies to explore firm-specific factors which might influence the economic effect of shareholder activism.

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[132] Christopher Clifford, "Value Creation or Destruction? Hedge Funds as Shareholder Activists" (2008) 14 Journal of Corporate Finance 323, 331.

[133] Martin Lipton, Empiricism and Experience; Activism and Short-Termism; the Real World of Business, Harvard Law School Forum on Corporate Governance and Financial Regulation, Accessed on September 4, 2019 at <https://corpgov.law.harvard.edu/2013/10/28/empiricism-and-experience-activism-and-short-termism-the-real-world-of-business/>.

Chapter 5 Case Studies on Institutional Shareholder Activism

The previous chapter argued that the benefits of institutional shareholder activism lie in its improvement to corporate governance. Its costs include self-interested activism, myopic activism and negative externalities to stakeholders. The previous chapter also suggested that the level of beneficial and detrimental effect of shareholder activism is likely to vary for different types of companies. This chapter hypothesizes that product market competitiveness, innovativeness, corporate life stage and organizational structures are likely to affect the outcome of institutional shareholder activism. It conducts case studies to tentatively test these hypotheses.

Section I introduces case study methodology. Section II introduces shareholder activism in the UK. Section III studies activism in Chesapeake and Hess to test the effect of product market competitiveness on the results of shareholder activism. Section IV examines activism in Motorola to study the relationship between innovativeness and shareholder activism. Section V analyzes activism in Apple, Darden and HP to explore the influence of corporate life stage on the outcome of shareholder activism. Section VI discusses activism in eBay and Timken to see the relationships between organizational structures and shareholder activism. Section VII concludes.

I. Case Study Methodology

Case studies examine subjects in contexts. Compared to theoretical and empirical studies which focus on a few key factors, case studies present more comprehensive and detailed pictures of the subjects.[1] Hence case studies are particularly suitable to examine subjects whose key factors cannot be clearly cut from the contexts.[2] This also makes case studies inductive to the formation of new hypotheses.[3]

One main objection against case studies is that their findings might not

[1] Pamela Baxter and Susan Jack, "Qualitative Case Study Methodology: Study Design and Implementation for Novice Researchers" (2008) 13 The Qualitative Report 544, 547.
[2] Ibid.
[3] Ibid.

generalized to cases in other contexts.[4] This argument is not entirely valid. If a case serves as a counter example to a hypothesis, its finding that the hypothesis is false can of course be generalized to all scenarios.[5] Generalization is more difficult in confirmatory case studies, but not impossible. For example, if controlling all variables, it can be argued that there is a causal link in an extreme cases, it must exist in other less extreme circumstances.[6] But case studies are important even when their findings cannot be generalized. Knowledge which applies to all cases, such as rules and principles, are often broad and abstract. To use them effectively, one must have experience, or an accumulation of context-specific information.[7] Case studies provide this type of knowledge.

Case studies are essential to the examination of institutional shareholder activism. This thesis starts by examining theoretical arguments and empirical data on the matter to present an outline of the issues. But institutional shareholder activism is a real life phenomenon. Without case studies, these theoretical and empirical studies lack background. Many factors which are important to the understanding of shareholder activism, such as the tension and interchange between activist shareholders and target companies, are also unlikely to be fully captured by theoretical and empirical studies. These studies have already been criticized for missing a taste of real life.[8] This chapter seeks to fill this gap in existing research.

This chapter traces back cases from 2017. As institutional shareholder activism is an ever-evolving phenomenon, more recent cases are preferred over older cases. Focus is placed on cases in the US. As will be discussed in Section II, there are fewer cases of shareholder activism in the UK. Shareholders and managers are generally averse to public confrontation in the UK, resulting in fewer observable cases. Most

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[4] Bent Flyvbjerg, "Five Misunderstandings About Case Study Research" (2013) 12 Qualitative Inquiry 219, 219.
[5] Ibid, 226.
[6] Ibid, 225.
[7] Ibid, 220.
[8] Martin Lipton, Empiricism and Experience; Activism and Short-Termism; the Real World of Business, Harvard Law School Forum on Corporate Governance and Financial Regulation, Accessed on September 4, 2019 at <https://corpgov.law.harvard.edu/2013/10/28/empiricism-and-experience-activism-and-short-termism-the-real-world-of-business/>.

publicized activism cases dealt with governance issues, which were quite straight-forward. Meanwhile, in the US, most activism campaigns were led by offensive activist shareholders on strategic issues. As self-interested and myopic activism is most likely to be associated with activism on strategic issues, the focus is placed on shareholder activism cases in the US. This chapter chooses cases where arguments from both activist shareholders and managers can be found. But this inevitably biases towards more confrontational cases. Because of its narrow focus and selection bias, this chapter does not seek to establish causal relationships between certain factors and the effect of institutional shareholder activism. It merely attempts to provide tentative support to its hypotheses, whose validity should be determined by future studies.

II. Institutional Shareholder Activism in the UK

After the subprime mortgage crisis, the government commissioned Sir David Walker to explore the causes of the crisis and to develop methods to avoid future crisis. In his report to the government, commonly known as the Walker Review, Sir David Walker named the lack of shareholder oversight as one of the key factors contributing to the crisis.[9] This view was shared by Lord Myners, who criticized institutional shareholders for being absentee landlords,[10] resulting in ownerless companies.[11] Heavily influenced by these views, the Financial Reporting Council introduced the Stewardship Code, which encourages institutional investors and fund managers to be more engaged with their portfolio companies.[12] Shareholders' say-on-pay power was also increased.[13] These changes led to an increase in

[9] Sir David Walker, A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations, Accessed on April 28, 2019 at <https://webarchive.nationalarchives.gov.uk/+/www.hm-treasury.gov.uk/d/walker_review_261109.pdf>, para 5.11.
[10] Kate Burgess, Myners Lashes out at Landlord Shareholders, Financial Times (April 21, 2009).
[11] Sean O'Grady, Myners Takes Role at Leading Firm of "Active Investors", The Independent (May 31, 2011).
[12] Financial Report Council, The UK Stewardship Code (July 2018), Principle 1.
[13] See Chapter 2.

shareholder activism, starting with the Shareholder Spring.[14]

In 2012, shareholders voted against executive remuneration in some of the largest companies in the UK. The campaign started with banks. The case of Barclays is a notable example. From as early as 2005, some employees of Barclays had been manipulating LIBOR, the inter-bank lending rate. Barclays admitted to misconduct in 2012 and paid a fine of £290 million.[15] In the meantime, Barclays paid its CEO Bob Diamond £17 million for his work in 2011.[16] This infuriated shareholders, one third of whom voted against Barclays's remuneration report. About 21% of shareholders voted against the reelection of the chairman of the remuneration committee,[17] who resigned afterwards.[18] Diamond gave up half of the payments[19] and later resigned for the LIBOR scandal.[20] However, the activism campaign failed to elicit responsible pay in Barclays. In 2014, executive bonuses were raised by 10% despite falling profits and mass layoffs.[21] The board sought to placate shareholders by promising to replace the chairman of the remuneration committee, John Sunderland. But a quarter of shareholders still voted against the remuneration report while another quarter abstained.[22] Sunderland remained in his position until 2015. He resigned after the Local Authority Pension Fund Forum publicly criticized Barclays for breaking its promise.[23]

The campaign quickly spread to other industries. AstraZeneca,[24] Centamin[25] and Aviva[26] all faced strong shareholder opposition against excessive executive remuneration. Since the Shareholder Spring, executive remuneration has become one

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[14] Kate Burgess and Dan McCrum, Boards Wake up to a Shareholder Spring, Financial Times, (May 4, 2012).
[15] BBC, Timeline: Libor-Fixing Scandal (February 6, 2013).
[16] Jill Treanor, Barclays Chief Bob Diamond Takes Home £17m in Pay, Shares and Perks, The Guardian (March 9, 2012).
[17] BBC, Barclays Stung by Shareholder Pay Revolt (April 27, 2012).
[18] Jill Treanor, Barclays Pay Chair Alison Carnwath Quits, The Guardian (July 25, 2012).
[19] BBC, supra note 17.
[20] BBC, supra note 15.
[21] Madison Marriage and Chris Newlands, Barclays Pay Board Attacked by Investors, Financial Times (March 9, 2015).
[22] Ibid.
[23] Madison Marriage, There are No Questions we are Afraid to Ask, Financial Times (April 12, 2015).
[24] Burgess and McCrum, supra note 14.
[25] Jill Treanor, Shareholder Spring: Gold Miner Pay Report Voted down over Bonus Row, The Guardian (May 30, 2012).
[26] Jill Treanor, Shareholder Spring Spreads to Aviva and William Hill, The Guardian (May 8, 2012).

of the most common issues of shareholder activism in the UK. For instance, in 2018 Aberdeen Standard Investment and Royal London Asset Management led a campaign against executive remuneration in Persimmon, a building company.[27] Shareholders argued that although Persimmon had good performance, most of it could be attributed to government schemes and the executives should not be rewarded extravagantly for that.[28] The remuneration report barely passed, with 51% of shareholders voted in its favour. The chairman of the board resigned, acknowledging that the company should improve its pay policies by having bonus caps.[29]

Shareholder activism in the UK is not limited to executive remuneration. For example, Sports Direct has seen several episodes of shareholder activism. Its founder and director, Mike Ashley, gave up his bonuses in 2014 after strong shareholder opposition.[30] It was revealed in 2015 that Sports Direct had extremely poor work practices, including denying employees of minimum wages.[31] The company also saw profits drop by 21%.[32] Institutional shareholders, including Standard Life, Aberdeen Asset Management and Legal General supported unions' effort to improve working conditions. They also sought to remove the chairman of the board, Keith Hellawell in the general meeting in 2016. About 54% of independent shareholders voted against Hellawell. But Hellawell was reelected because he had the support of Ashley who held 55% of shares.[33] Shareholders also sought but failed to remove Hellawell in 2017.[34] Hellawell resigned before the general meeting in 2018.[35] Meanwhile, Ashley attempted to pay his brother £11 million in 2017[36] and his future son-in-law £5

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[27] Aime Williams and Attracta Mooney, Persimmon Hit by Pay Revolt at AGM, Financial Times (April 25, 2018).
[28] Ashley Hamilton Claxton, How Shareholder Activism is Driving Better Corporate Governance, Pensions Expert (January 17, 2018).
[29] Williams and Mooney, supra note 27.
[30] Attracta Mooney, Sports Direct Shareholders Urged to Vote against Directors, Financial Times (August 22, 2018).
[31] Simon Goodley and Jonathan Ashby, Revealed: How Sports Direct Effectively Pays below Minimum Wage, The Guardian (December 9, 2015).
[32] Matthew Weaver, Sean Farrell and Sarah Butler, Sports Direct Founder Mike Ashley Lashes out at Unite Union, The Guardian (September 7, 2016).
[33] Rupert Steiner, Sports Direct Loses Biggest Independent Investor, The Guardian (August 3, 2017).
[34] Mooney, supra note 30.
[35] Sarah Butler, Mike Ashley Launches Tirade against Sports Direct Shareholders, The Guardian (September 14, 2018).
[36] Ibid.

million in 2018.[37] This resulted in 38% of independent shareholders voting against his reelection in 2018.[38]

Institutional shareholders in the UK have also become more active on strategic issues. For example, in 2017 Schroders Investment Management and Artisan Partners led an unsuccessful campaign to oppose Tesco's acquisition of Booker.[39] Shareholders of Unilever also successfully vetoed the board's decision to move the company's headquarter to the Netherlands.[40]

The UK has increasingly seen activism led by hedge funds in the US. One notable example is Trian Partners's success in making Cadbury sell its beverage division in 2008.[41] But most activist hedge funds encountered more difficulties in the UK than in the US. For example, in 2014, Elliot Management asked Morrisons to spin off its real estate.[42] Although such proposal is common in the US, most shareholders of Morrisons considered it highly dangerous. Elliot did not take further actions.[43] Elliot's activism in Alliance Trust was also viewed cautiously by shareholders. In 2011, the share price of Alliance Trust, an investment trust, was 10% lower than its peers.[44] Elliot proposed a restructuring plan, including selling the investment management division and outsourcing the management of equity portfolios.[45] But it later agreed to a compromise with the company, presumably because Elliot did not secure sufficient shareholder support. According to the agreement the board appointed two non-executive directors chosen by Elliot and Elliot refrained from publicly

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[37] William Turvill, Sports Direct Boss Mike Ashley Facing Storm of Criticism over Continued Failures at the Firm, This is Money (September 1, 2018).
[38] Butler, supra note.
[39] Mark Vandevelde, Two Big Tesco Shareholders Come Out Against Booker Takeover, Financial Times 2017.
[40] Attrata Mooney, Unilever U-Turn Shows How Angry Shareholders Are Seeming Change, Financial Times, 2018.
[41] Michael De La Merced, Kraft, Cadbury and the Peltz Factor, The New York Times (September 7, 2009).
[42] Katherine Rushton and Graham Ruddick, Wall Street Planning Assault on UK, The Telegraph (February 8, 2014).
[43] Graham Ruddick, Morrisons Shareholders Warn over Incredibly Dangerous Plan to Sell Stores, The Telegraph (January 12, 2014).
[44] Tim Wallace, How Alliance Trust's Long Battle with Activist has Unfolded, The Telegraph (October 1, 2015).
[45] Lauren Fedor, Alliance Trust to Buy Shares Owned by Activist Elliot, Financial Times (January 27, 2017).

challenging the board until 2016.[46] But the performance of Alliance Trust kept deteriorating. This eventually led the board to implement Elliot's proposal.[47]

Before the subprime mortgage crisis, shareholder activism was rare in the UK. The few cases include Fidelity's activism in ITV[48] and Laxey Partners' activism in British Land.[49] This is because the UK has a tradition of self-regulation which results in relatively cooperative relationships between shareholders and managers. Unlike shareholders in the US, shareholders in the UK are less comfortable with public confrontation with the management. Elliot's experience in the UK supports this point. Instead, dissatisfied shareholders in the UK are more likely to address their concerns in private negotiations with the management. As they have strong voting rights which make managers more receptive to their voice, there is less need for shareholders to take further confrontational steps. These explain why there are fewer observable cases of shareholder activism in the UK than in the US.

III. Competitiveness of the Product Market

1. Overview

As the advantage of institutional shareholder activism lies mainly in its improvement to corporate governance, shareholder activism would be particularly beneficial to companies with weak governance. One factor which might affect a company's governance quality is competitiveness of its product market.

Instead of maximizing profits, managers with agency problems only produce a satisfactory level of profits to ensure that no corporate governance mechanism is triggered.[50] When costs decrease as the company benefits from experience curves and

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[46] Angela Monaghan, Alliance Trust Strikes Deal with Elliot Advisors, The Guardian (April 28, 2015).
[47] Fedor, supra note 45.
[48] Hugo Dixon, Green's Last Stand, Reuters, (October 19, 2003).
[49] Helena Keers, British Land Pressure Eases as Laxey Drops Demands and Disposes of Stakes, The Telegraph (June 17, 2003).
[50] Oliver Hart, "The Market Mechanism as an Incentive Scheme" (1983) 14 The Bell Journal of Economics 366, 367.

other factors, more profits are available to the company.[51] But as managers only seek to maintain a satisfactory level of profits, they would consume the surplus themselves by exerting less effort. This is the phenomenon of x-inefficiency observed by Leibenstein.[52]

Competition changes managerial behavior. Assuming products are homogenous, competition moves prices closer to costs.[53] As companies are less profitable and have higher probabilities of insolvency, managers must exert more effort to reach satisfactory profit levels and to avoid insolvency.[54] On the other hand, in a highly competitive market, managers might believe that they cannot reach the satisfactory profit level whatsoever and exert no effort at all.[55] Fee and Hadlock studied managerial turnover in the US newspaper industry between 1950 and 1993. They found that managerial turnover rates in underperforming companies were 27% higher in regions where competition is the most intense than in the least competitive regions.[56] They argued that this was because managers chose to find other employment instead of improving corporate performance against intense competition.[57] Hence the relationship between managerial incentives to shirk and competition is likely to be u-shaped. Managerial slack would be serious in companies in monopolistic markets. Managers have incentives to exert more effort as competition grows, but would revert back to shirking when competition becomes overly intense.[58]

When competition induces managers to reduce agency costs voluntarily, it is a

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[51] Bruce Henderson, "The Experience Curve Reviewed: History" in Carl Stern and Michael Deimler (eds) *The Boston Consulting Group on Strategy* (John Wiley & Sons, 2006) 12.
[52] Harvey Leibenstein, "On the Basic Proposition of X-Efficiency Theory" (1978) 68 American Economic Association 328, 328.
[53] Donald Alexander and Huizhong Zhou, "Product Market Competition and Executive Compensation" (1995) 47 Journal of Economics and Business 441, 445.
[54] Hart, supra note 50, 367.
[55] Barry Nalebuff and Joseph Stiglitz, "Prices and Incentives: Toward a General Theory of Compensation and Comeptition" (1983) 14 The Bell Journal of Economics 21, 29.
[56] Edward Fee and Charles Hadlock, "Managerial Turnover and Product Market Competition: Empirical Evidence from the US Newspaper Industry" (2000) 73 The Journal of Business 205, 226.
[57] Ibid, 212.
[58] Klaus Schmidt, "Managerial Incentives and Product Market Competition" (1997) 64 The Review of Economic Studies 191, 201.

substitute to other governance mechanisms.[59] Allen and Gale studied non-profit organizations operating in relatively competitive markets. They found that these organizations had self-perpetuating boards, no incentive payment for managers and a non-existent market for corporate control. But these organizations performed better than some for-profit companies with complete governance systems.[60] When intensive competition gives managers incentives to incur higher agency costs, the costs could be controlled by enhanced incentive alignment. For example, Alexander and Zhou found that companies in more competitive markets gave their CEOs larger proportions of performance-based remuneration to induce managerial effort.[61] Competition also facilitates monitoring by the board and shareholders as managerial quality is more observable by comparing the company's performance with the performance of its competitors.[62] This makes identifying takeover targets easier as well.[63] Thus even when competition increases managerial incentives to incur agency costs, it still complements other governance mechanisms to control agency costs.[64]

This chapter hypothesizes that companies in less competitive markets have higher agency costs, which makes corporate governance and institutional shareholder activism more valuable to them than to companies in more competitive markets. The next two parts of this section studies shareholder activism in oil companies to test this hypothesis. The rest of this part explores existing methods to evaluate an industry's competitiveness.

The main quantitative approach to assess the level of market competition is to calculate its Herfindahl Index, which is the sum of the square of each market participant's market share.[65] This approach is based on the assumption that the level of competition grows as the number of competitors increases. But market

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[59] Julia Chou, Lilian Ng, Valeriy Sibilkov and Qinghai Wang, "Product Market Competition and Corporate Governance" (2011) 1 Review of Development Finance 114, 115.
[60] Frank Allen and Douglas Gale, Corporate Governance and Competition Accessed on June 19, 2017 < http://finance.wharton.upenn.edu/~allenf/download/Vita/corpgov.pdf> at 23.
[61] Donald Alexander and Huizhong Zhou, "Product Market Competition and Executive Compensation" (1995) 47 Journal of Economics and Business 441, 445.
[62] Chou et al, supra 59, 115.
[63] Ibid.
[64] Benjamin Hermalin, "The Effects of Competition on Executive Behavior" (1992) 23 The RAND Journal of Economics 350, 350.
[65] Richard Whish and David Bailey, *Competition Law* (7th edn OUP, 2012) 43.

concentration does not necessarily translate into non-competitiveness. Thus the H index is mostly used to screen out obviously competitive industries, not to provide definitive proof on an industry's non-competitiveness.[66]

Some legal reforms provide researchers opportunities to examine the effect of increased competition while controlling for other factors. For example, Griffth studied corporate productivity before and after the introduction of the EU Single Market Program. The program increased competition in industries where non-tariff barriers were high *ex ante* but did not significantly affect industries which were already competitive.[67] Griffth found that companies in previously non-competitive industries experienced significant growth in productivity after the introduction of the single market program while companies in *ex ante* competitive markets had lower growth rates. Hence she concluded that there was a positive correlation between competition and productive efficiency.[68] The drawback of event studies is that suitable events are rare. This chapter employs a qualitative approach to evaluate the oil industry's level of competition, using the analytical tool of Porter's five competitive forces.[69]

Porter proposed that an industry's level of competition is determined by five forces. The first force is the threat of new entries. Examples of high entry barriers include large capital requirements, need for rare resources and consumer loyalty to existing brands.[70] The second and third forces are the market power of suppliers and buyers. When suppliers and buyers have more power *vis-à-vis* the company, they have greater control on the prices at which supplies are provided or products are sold and their qualities. This reduces the company's profits and makes the market more competitive.[71] Substitutability of the products is the fourth competitive force.[72] A product which can only be produced by a specific company, mostly because the

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[66] Ibid, 44.
[67] Rachel Griffth, Product Market Competition, Efficiency and Agency Costs: An Empirical Analysis, The Institute for Fiscal Studies Working Paper 01/12, Accessed on April 12, 2019 at <https://pdfs.semanticscholar.org/99d1/18eb80a8ddf14701d2e1b2d0f067f8ffd782.pdf>, 22.
[68] Ibid.
[69] Michael Porter, "How Competitive Forces Shape Strategy" (1979) Harvard Business Review 137, 138.
[70] Ibid.
[71] Ibid, 140
[72] Ibid, 142.

company holds the patent, faces less competition than generic products such as consumer goods. The last competitive force is rivalry, which refers to the aggressiveness of competitors.[73]

Three out of the five competitive forces are weak for the oil industry. The threat of new entry is small. To start up a company to drill oil, large amounts of capital are needed, not only monetary, but also political capital to gain permissions to drill oil in certain places. Most oil companies have patented technologies to minimize costs and maximize production,[74] without which new entrants are unlikely to compete successfully with the incumbents. Most oil companies are vertically integrated. A typical oil company has upstream exploration divisions to identify oil fields and production divisions for drilling and extracting oil. It has midstream divisions for oil refinery and storage as well as downstream divisions for distribution and retail.[75] Supplier and buyer power is minimal for vertically integrated oil companies. Rivalry is not intense among oil companies.[76] The one force that is strong for oil companies is product substitutability. Oil is a commodity and an oil company cannot differentiate its product from the product of its competitors.[77] But overall, the oil industry is a relatively non-competitive industry. This section then studies shareholder activism in two oil companies, Chesapeake and Hess, to examine whether corporate governance was indeed weak and whether it was improved by shareholder activism.

2. Chesapeake

Chesapeake Energy Corporation is the second largest producer of oil and gas in the US. In 2012, it was revealed that its CEO and chairman McClendon ran a hedge fund which traded commodities including oil and gas.[78] This created serious conflicts

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[73] Ibid.
[74] Mohammed Hokroh, "An Analysis of the Oil and Gas Industry's Competitiveness Using Porter's Five Forces Framework" (2014) 3 Global Journal of Commerce and Management Perspective 76, 77.
[75] Investopedia, The Industry Handbook, Accessed on May 4, 2017 at <http://i.investopedia.com/inv/pdf/tutorials/industryhandbook.pdf>, 8.
[76] Hokroh, supra note 74, 79.
[77] Ibid.
[78] Joshua Schneyer, Jeanine Prezioso and David Sheppard, Special Report: Inside Chesapeake, CEO

of interest, because McClendon's decisions as CEO and chairman might not be made in the company's interests, but for the benefits of the hedge fund. Indeed, in 2008 the hedge fund used leverage to purchase a large position in Chesapeake. When it could not meet margin calls, the fund sold most of its positions. The large sale caused Chesapeake's share price to plummet.[79] As founder of Chesapeake, McClendon owned 2.5% of each of the company's oil and gas wells. It was revealed in 2012 that he took a personal loan of $1.1 billion by using his interests in the wells as collateral. After the loan was made public, S&P downgraded the company's credit rating, which depressed the company's share price.[80]

The board of Chesapeake claimed that it was not aware of and did not approve the loans.[81] But since the company chose to award its founders ownership interests over corporate properties, special attention should have been paid to whether the founders exercised their ownership rights in ways that would be detrimental to the company. It was unclear whether the board knew about the hedge fund. Given the serious nature of the conflicts of interest, if McClendon had disclosed his dealings to the board, the board should have asked him to resign from either the hedge fund or the company. Even if McClendon had not informed the board of the hedge fund, the board ought to have inquired into the unusual fluctuations of the company's share price and had a good chance of discovering McClendon's conflicts of interest. Thus in either case the board was ineffective.

The board conducted an inquiry after McClendon's dealings were publicized and concluded that McClendon did not make improper profits at the expense of the company.[82] This prompted shareholders to take matters in their own hands. Ontario Teachers' Pension Plan Board led a class action against Chesapeake for withholding material information from investors. The suit was dismissed because shareholders could not establish the company's intent to defraud investors by omitting the

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Ran $200 million Hedge Fund, Reuters (May 2, 2012).

[79] Ibid.

[80] Ernest Scheyder and Brian Grow, SEC Starts Probe of Chesapeake CEO's Well Stakes, Reuters (April 26, 2012).

[81] Ibid.

[82] Saabira Chaudhuri, Chesapeake Financing Review Finds no Improper Benefit to CEO, The Wall Street Journal (February 20, 2013).

information.[83] In that year's general meeting, two directors received less than 27% of votes for reelection. Only 20% of votes were casted in favour of the company's executive remuneration.[84] Eventually four out of nine directors were replaced with shareholder representatives, one nominated by Icahn Enterprise and three by Southeastern Asset Management.[85] McClendon also resigned from his positions as CEO and chairman of the board.[86]

Shareholder activism at Chesapeake improved board monitoring and is likely to be beneficial. The company's share price did rise after the general meeting,[87] supporting the hypothesis that companies in relatively non-competitive markets have weak corporate governance and are likely to benefit from shareholder activism.

3. Hess

Hess is a S&P 500 company. In 2013, several facts suggest that it had a weak corporate governance structure. First, the company's board governance was weak. The board was classified and the company's articles required 80% of outstanding shares to declassify the board.[88] This requirement allowed directors to use their shares to block shareholder initiated declassification in 2007, 2008 and 2012.[89] Although the company claimed that twelve out of its fourteen directors were independent, up to 2012, average tenure of the directors was 13 years.[90] General assumption is that non-executive directors are no longer independent after serving for nine years.[91] In 2012, one third of votes were withheld against reelections of three directors, despite the fact that average withheld rates for directors of S&P 500 companies that year was

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[83] Chesapeake Energy Wins Dismissal of Shareholder Law Suit, Reuters (April 11, 2013).
[84] David Benoit, Chesapeake Shareholders in Historic Revolt, The Wall Street Journal (June 8, 2012).
[85] Arathy Nair, Icahn Nominee Resigns from Chesapeake Board, Shares Tumble, Reuters (September 27, 2016).
[86] Richard Levick, The J.R. Ewing Syndrome: Chesapeake Energy and Aubrey McClendon, Forbes (June 12, 2012).
[87] Benoit, supra note 84.
[88] Elliot Management's Perspectives on Hess, Accessed on May 4, 2017 at <https://www.sec.gov/Archives/edgar/data/4447/000110465913005512/a13-3887_2ex1.pdf>, 43.
[89] Ibid.
[90] Ibid, 17.
[91] The Corporate Governance Code, supra note 12, 2.10.

3.7%.[92] Second, Hess chose companies which were much larger than itself as benchmarks to increase managerial remuneration. In 2012, its executive remuneration received only 51% of shareholder support, which ranked 427th among S&P 500 companies.[93] Third, shareholder voting rights were weaker in Hess than in other companies. Removal of directors required two thirds of outstanding shares[94] and amendment of articles needed 80% of outstanding shares.[95] These requirements allowed directors to use their share ownership to block shareholder actions.

In 2013, hedge fund Elliot Management launched a proxy fight to replace five directors.[96] It also requested the company to focus on its core business and have more discipline with capital expenditure. Elliot argued that between 2007 and 2012, Hess spent $4 billion to explore new oil fields, which were loosely related to its core assets and all ended up in failure.[97] To finance the explorations, Hess made small shareholder payouts. In return, investors discounted Hess's share price, assuming that the company would keep investing in unsuccessful explorations and have low shareholder payout ratios.[98] Elliot argued that the company should focus on its core assets, oil fields which it explored with Exxon Mobile and the Bakken shale field. Other explorations should be stopped, non-core assets should be divested and capital should be returned to shareholders.[99] Although activism by Elliot attracted the most attention, the company's other shareholders also joined the effort. Indiana Laborers' Pension Fund submitted a proposal to separate the role of CEO and chairman of the board.[100] Trillium Asset Management made a shareholder proposal requiring the company to disclose its political contributions.[101] An individual shareholder, James McRitchie also made a shareholder proposal for a simple majority rule for all

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[92] Elliot, supra note 88, 9.
[93] Ibid.
[94] Hess Corporation, Schedule 14a (March 21, 2013), Accessed on May 31, 2017 at <http://services.corporate-ir.net/SEC.Enhanced/SecCapsule.aspx?c=101801&fid=8713386>.
[95] Elliot, supra note 88, 51.
[96] Hess, supra note 94, 90.
[97] Elliot, supra note 88, 5.
[98] Ibid, 57.
[99] Ibid, 47.
[100] Hess, supra note 94, 77.
[101] Ibid, 83.

corporate matters.[102]

Initially the company decided to fight against the activism campaign. The board recommended shareholders to vote against all shareholder proposals. It argued that a high threshold for some important corporate actions protects the company from self-interested shareholders.[103] It also argued that the political contributions questioned by the shareholders were made years ago and were of an insignificant amount. As the company had no intention to make further political donations, the proposal was unnecessary.[104] More importantly, the company revealed a payment arrangement between Elliot and its director nominees, according to which each director nominee had received $50, 000 for participating in the proxy fight and would receive a bonus if the company could outperform its peers in three years.[105]

As general shareholder opinion was against the payments, Elliot had no choice but to terminate the payment arrangement.[106] Meanwhile, Hess made several concessions. John Hess stepped down as chairman of the board.[107] A number of downstream subsidiaries and overseas assets were divested.[108] Eventually, the company and Elliot reached an agreement. Elliot withdrew its proxy fight and supported five of the company's nominees. In exchange, three of Elliot's nominees were appointed to the board.[109] The general meeting also passed shareholder proposals on the adoption of single majority rule.[110]

From a pure corporate governance perspective, shareholder activism was beneficial to Hess as it improved board monitoring and enhanced shareholder voting rights. But it did not stop Hess's share price from dropping. In 2017, Elliot sought to remove John Hess as the CEO and suggested the company buy back shares to boost

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[102] Ibid, 80.
[103] Ibid, 87.
[104] Ibid, 90.
[105] Edward Iacobucci, "Special Compensation Arrangements for Dissident Directors in Proxy Contests: A Policy Analysis" (2014) 55 Canadian Business Law Journal 365, 366.
[106] Daniel Gilbert, Hess Offers Activist Two Board Seats to End Proxy Fight, The Wall Street Journal (May 13, 2013).
[107] Michael De La Merced, How Elliot and Hess Settled a Bitter Proxy Battle, The New York Times (May 16, 2013).
[108] Swetha Gopinath and Michael Erman, Hess Files to Spin off Gas Station Business, Reuters (January 8, 2014).
[109] De La Merced, supra note 107.
[110] Business Wire, Hess Corporation Announces Results of Annual Meeting (May 16, 2013).

its share price.[111] The board, including directors nominated by Elliot, supported John Hess and his strategy. Elliot took no further action.[112] In January 2018, two oil fields were discovered by Hess and Exxon Mobil in Guyana, greatly improving Hess's performance.[113]

Hess's case supports the hypothesis that companies in relatively non-competitive markets have poor corporate governance and are particularly likely to benefit from shareholder activism. Hess board's resistance to Elliot's second activism attempt also supports the argument made in the previous chapter, that directors nominated by activist shareholders are more likely to act for the interests of the company, not for those of activist shareholders, although the situation would be different if directors accepted payments from activist shareholders. Finally, Hess's case demonstrates that activist shareholders are not always hostile and myopic. When companies have functioning corporate governance systems, they are more receptive of managerial opinions and are more willing to wait for the realization of long-term value.

IV. Innovativeness

1. Overview

Whether a company's business is innovative affects the economic impact of institutional shareholder activism. To be able to innovate, a company's decision-makers must have profound knowledge of the company and expertise in the relevant business field, which is why most innovative companies have a majority of inside directors.[114] Innovation requires long-term investments and entails a high level

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[111] Alex Nussbaum, As Elliot Seeks Revamp, a Frustrated Hess Pushes Long View, Bloomberg (February 9, 2018).
[112] David French, Jessica Resnick-Ault, Ernest Scheyder and Karina Dsouze, Hedge Fund Elliot Prepares Second Challenge to Hess Corp, Reuters (December 14, 2017).
[113] Dave Meats, Closer Look at Hess's Guyana Stake Raises our FVE, The Morning Star (September 12, 2018).
[114] Barry Baysinger, Rita Kosnik and Thomas Turk, "Effects of Board and Ownership Structure on Corporate R&D" (1991) 34 The Academy of Management Journal 205, 209.

of risk.[115] Hence to encourage innovation, managers must be reassured that they would not be removed or be paid based on the company's performance in the short term. Many innovative companies have multiple classes of shares to insulate their managers from short-term pressure.[116] Thus it can be said that innovative companies sacrifice good corporate governance for innovation. But this does not mean corporate governance is unnecessary. In fact, the agency problem is more serious a concern for innovative companies than for low technology companies. Information asymmetry is severe between managers of innovative companies and retail investors,[117] reducing the effectiveness of market discipline. This, combined with weak board monitoring, allows managers to impose high agency costs on the company. As institutional shareholders are more capable to evaluate innovative companies, their activism can fill the governance gap and would be more valuable to innovative companies than to low technology companies. However, as the success of innovative companies depends on their abilities to innovate, myopic shareholder activism would do more harm to innovative companies than to low technology companies. Thus both the beneficial and detrimental effect of institutional shareholder activism is heightened for innovative companies. The rest of this section examines shareholder activism at Motorola and shows that myopic activism is indeed particularly detrimental to innovative companies. The next section studies shareholder activism at Apple, which illustrates the benefits innovative companies can get from shareholder activism.

2. Motorola

Up until 2006, Motorola was the second largest cell phone seller in the world. Its 2004 release of the Razr, a model of flip phone, was a huge market success.[118] But

[115] Houman Shadab, "Innovation and Corporate Governance: The Impact of Sarbanes-Oxley" (2008) 10 University of Pennsylvania Journal of Business and Employment Law 955, 963.

[116] Vijay Govindarajan, Shivaram Rajgopal, Anup Srivastava and Luminita Enache, Should Dual Class Shares Be Banned? Harvard Business Review (December 3, 2018).

[117] Bengt Holmstrom, "Agency Costs and Innovation" (1989) 12 Journal of Economic Behavior and Organization 305, 309.

[118] Christopher Rhoads and Li Yuan, How Motorola Fell A Giant Step Behind, The Wall Street Journal (April 27, 2007).

the company made several poor decisions since then. The success of the Razr tempted the company to introduce a series of updated models. This excessive focus on the Razr led the company to neglect new product development, especially to embrace 3G technology. As a result, Motorola saw a decrease of profits and a consequent drop in its share price in 2006 when consumers switched to new products offered by its competitors.[119] It was at this time that Icahn Enterprise purchased shares in the company. Icahn asked the company to use its entire cash reserve, $9 billion, to repurchase shares.[120] In the end, Motorola bought back $5 billion worth of shares.[121] Such activism might be harmless to other companies, but it was detrimental to Motorola. Motorola needed to develop new products to catch up with competition. It might have achieved that by acquiring companies which had designed new models or by investing more in internal innovation to speed up the process. Reducing the company's cash reserves seriously constrained its options, especially when the company was already facing sharp drops in profits. The detrimental effect of the activism was obvious, as Motorola failed at new product development and was reduced to an insignificant market share.

But Icahn's activism had not been concluded. As the company's performance kept deteriorating, Icahn argued that the company should be broken up to give managers more focus. The company obliged. In 2008, Motorola was split into Motorola Mobility and Motorola Solutions, with the former focusing on cell phones and tablets while the latter focusing on radios.[122] Motorola Mobility was acquired by Google in 2011 at $12.5 billion. General consensus was that Icahn made a fortune from the acquisition.[123] Shortly afterwards, Motorola Solutions purchased Icahn's shares at $1.17 billion which concluded Icahn's activism campaign in Motorola.[124] The breakup of Motorola is likely to be myopic. Motorola's radio business generated

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[119] Ibid.
[120] Roben Farzad, Why Icahn May Hurt Motorola, Bloomberg (March 29, 2007).
[121] Ibid.
[122] Sinead Carew, Motorola to Split into Two Companies in 2009, Reuters (March 26, 2008).
[123] Shira Ovide, Google-Motorola: Carl Icahn Looks Brilliant, The Wall Street Journal (August 15, 2011).
[124] Sayantani Ghosh, Motorola Solutions Buys BACK $1.17 Billion of shares from Icahn, Reuters (February 27, 2012).

strong cash inflows[125] which could have supported its innovation. The subsidies might have led to the radio business being undervalued for some time. But given the strength of Motorola's brand, the company had a high probability of making good the losses once it caught up with innovation. Separating the radio and cellphone business further destroyed the latter's innovative capacity. Presumably the breakup was motivated by Icahn's desire to make quick returns by making Motorola Mobility a more attractive target for takeovers.

While shareholder activism significantly reduced the value of Motorola, a number of companies, such as DuPont[126] and Nestle,[127] conceded to similar shareholder activism and suffered little negative consequences. This supports the hypothesis that myopic shareholder activism is particularly detrimental to innovative companies. But it cannot explain why similar activism did no observable harm to other innovative companies, such as Apple.[128] The difference lies in corporate life stages. At the time of Icahn's activism, Motorola was at the decline stage. Its deceasing profits made its cash reserves and cash inflows from the radio division extremely important. Meanwhile, Apple was a mature company, whose strong and stable earnings made large cash reserves unnecessary. The next section explores this issue further.

V. Corporate Life Stage

1. Overview

Generally there are four stages in a business life cycle. At the startup stage, the company is developing a new product. This new product could also be a new type of

[125] Mark Veverka, Will the Real Motorola Please Stand Up? Barron's (September 3, 2011).
[126] Kaja Whitehouse, DuPont Plans $4B Share Buyback amid Activist Pressure, USA Today (January 27, 2015).
[127] Rachael Levy, The $265 Billion Target of an Activist Hedge Fund just Announced $21 Billion in Share Buybacks, Business Insider (January 27, 2017).
[128] See the next section.

service or a new way to produce or sell existing products.[129] Once the company has a preliminary product, it proceeds to create a market for the product and enters into the growing stage during which there is rising demand for the product.[130] The company improves and finalizes the product as well as the production process. Competitors also enter into the market at this stage. The scale and time of new entry depends on the availability of production resources and substitute products.[131] For example, once a brand introduces a new fashion style, other brands are able to follow quickly by offering similar designs. Meanwhile, imitation is much more difficult in the pharmaceutical industry where most initial producers have patents on the technologies used. When competition arises, initial producers are likely to be outcompeted by new entrants because they have spent more resources in product development and have to charge higher prices to recover costs.[132] For some initial producers, although the demand for the product is rising, their market share is shrinking and they enter into the decline stage. For other companies, eventually the demand for the product and their market share stablize and they enter into the maturity stage.[133] They enter into the decline stage when the demand for their products declines. This usually happens when a superior product is produced.[134] Many companies are liquidated while others are successfully turned around and return back to earlier stages of development. Most companies have multiple business lines at different life stages to avoid decline and to finance new product development.[135] Thus a company's life stage is determined by the life stages of the majority of its products.

At the beginning of a company's life, it is typically being controlled by a few entrepreneurs who have contributed their personal wealth to the company. The company might also be financed by bank loans, but most banks are passive at this

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[129] Cedric Schneider and Reinhilde Veugelers, "On Young Highly Innovative Companies: Why They Matter and How (Not) to Policy Support Them" (2010) 19 Industrial Corporate Change 969, 974.
[130] Theodore Levitt, "Exploit the Product Life Cycle" (1965) Harvard Business Review 81, 81.
[131] Ibid, 84.
[132] Ibid 83.
[133] Ibid, 81.
[134] Ibid, 87.
[135] Bruce Henderson, "The Product Portfolio" in Carl Stern and Michael Deimler (eds) *The Boston Consulting Group on Strategy* (John Wiley & Sons, 2006) 37.

early stage.[136] If the development goes well, the company might be able to secure investments from business angles and venture capital funds. These investors take large shareholdings and constantly monitor the company,[137] resulting in a young company having minimal separation of ownership and control. As the company grows, the amount of capital it needs can no longer be secured in the private equity market and the company has to offer its shares to public shareholders. The initial public offering is a turning point where some venture capital funds exit the company.[138] The positions of remaining shareholders and entrepreneurs are diluted by newly issued shares. In the US and the UK where most investors choose not to take large positions, the company's share ownership becomes dispersed.[139] Meanwhile, as the company grows, its objectives expand significantly, from product development to tasks such as marketing, investing and relationship building with suppliers, distributors and competitors. Managing also becomes more demanding as the company grows and has more employees. Gradually these tasks fall outside the scope of entrepreneurs who are mostly technological experts. Hence professional managers are brought in.[140] The introduction of highly specialized managers results in managerial responsibilities, which used to be shared by a few entrepreneurs being defined and allocated formally. As control of the company is exercised by managers who have small shareholdings, the separation of ownership and control and the consequent agency problem become serious concerns.[141] Therefore, companies at later life stages have greater need for corporate governance and are more likely to benefit from hedge fund activism.

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[136] Andrew Winton and Vijay Yerramilli, "Entrepreneurial Finance: Banks versus Venture Capital" (2008) 88 Journal of Financial Economics 51, 52.
[137] Ibid.
[138] Susanne Espenlaub, Marc Goergen and Arif Khurshed, "Governance Implications of Locked-in Venture Capitalists and Founder Owners in Newly Floated UK Companies" in Igor Filatotchev and Mike Wright (eds) *The Life Cycle of Corporate Governance* (Edward Elgar, 2005) 99.
[139] Steve Toms, "The Life Cycle of Corporate Governance" in Mike Wright, Donald Siegel, Kevin Keasey and Igor Filatotchev (eds) *The Oxford Handbook of Corporate Governance* (OUP 2013) 357.
[140] Shaker Zahra and James Hayton, "Organizational Life-Cycle Transitions and Their Consequences for the Governance of Entrepreneurial Firm: An Analysis of Start-Up and Adolescent High-Technology New Ventures" in Igor Filatotchev and Mike Wright (eds) *The Life Cycle of Corporate Governance* (Edward Elgar, 2005) 34.
[141] Toms, supra note 139, 356.

2. Apple

In May 2012, Greenlight Capital, a New York based hedge fund, asked Apple to reduce its $137 billion cash reserves by issuing preferred shares.[142] Apple's refusal was clearly shown in Proposal 2 of its proxy card for 2013, part of which asked for shareholder approval to eliminate the board's power to unilaterally issue preferred shares.[143] In a shareholder conference in February 2013, Greenlight outlined its plan and urged shareholders to support it by voting against the board's proposal.

Greenlight suggested Apple award each common share with five iPrefs. IPrefs would be listed perpetual preferred shares with no maturity date. They would have a face value of $50 and a quarterly yield of $0.50. In the event of Apple's liquidation, holders of iPrefs would be paid before common shareholders.[144] According to Greenlight, iPrefs would have two advantages. First, Apple would gradually reduce its cash reserves by paying dividends on iPrefs. Total payments would be around $10 billion annually. Compared to more traditional ways to reduce cash reserves, such as by paying one-time dividends or buying back shares, this way of reduction would protect Apple's financial flexibility.[145] Second, as iPrefs would be publicly traded, they would attract investors who are more risk-averse, moving the company's price closer to its real value.[146]

Despite all the advantages argued by Greenlight, it appeared that Proposal 2 was likely to pass. To prevent this from happening, Greenlight sued Apple on the grounds that Proposal 2 violated Section 14e of the Securities Exchange Act of 1934 by bundling several proposals into one, which denied shareholders the right to vote on each separate issue.[147] Greenlight also sought a preliminary injunction to enjoin Apple from certifying proxies which had been granted to it and proceeding with the

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[142] Greenlight, IPrefs: Unlocking Value, Accessed on April 13, 2019 at <https://www.businessinsider.com/greenlight-capitals-apple-presentation-2013-2?r=US&IR=T#-32>, 33.
[143] Apple Inc, Schedule 14a (February 27, 2013) accessed on April 13, 2019 at <https://www.sec.gov/Archives/edgar/data/320193/000119312513005529/d450591ddef14a.htm>, 29.
[144] Greenlight, supra note 142, 33.
[145] Ibid, 43.
[146] Ibid, 34.
[147] Greenlight Capital LP v Apple Inc No. 13 Civ 900 (RJS) (S.D.N.Y.Feb.22, 2013), 6.

general meeting.[148] For preliminary injunctions to be granted, the parties seeking relief must demonstrate that they are likely to succeed on the merits of the case, that they are likely to suffer from irreparable harm if the relief is not granted, that the balance of harm tips to their favour and that granting the injunction is in the public interest.[149]

The proposal in question asked shareholder approval to amend the company's articles of association on four matters, namely to adopt majority voting for director elections, to remove the board's power to issue preferred shares without shareholder approval, to establish a par value for its shares and to eliminate clauses on preference shares from its articles of association.[150] Apple argued that they were not separate matters because they all concerned the amendment of articles.[151] Apple further argued that all four matters were ministerial or technical, which qualified for the exception to Section 14e. For example, the board's blank check power to issue preference shares is nonmaterial because the board had never and would never issue preference shares without shareholder approval.[152] Both arguments did not convince the court. The court ruled that if Apple's practice was allowed, Section 14e would only be applicable to the most egregious cases of bundling.[153] As to the materiality of the matters, the judgment should be made by shareholders, not the board.[154] Thus Greenlight succeeded in showing a more than fifty percent probability of success. Apple argued that shareholders would suffer no harm from the proposal as they could always amend the articles.[155] This argument was not accepted by the court. According to the court, the harm lies in shareholders being forced to cast votes unrepresentative of their views.[156] Hence Greenlight would suffer irreparable harm without the injunction. As the balance of harm tipped in Greenlight's favor and granting the injunction was in the

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[148] Ibid, 4.
[149] Ibid, 5.
[150] Apple, supra note 143.
[151] Greenlight v Apple, supra note 147, 7.
[152] Ibid, 8.
[153] Ibid, 7.
[154] Ibid, 9.
[155] Ibid, 10.
[156] Ibid.

public interest, the court granted Greenlight the injunction it sought.[157] Afterwards Apple withdrew Proposal 2 from its proxy card. It then announced a plan to return $100 billion of its cash reserves to shareholders. This included a 15% raise of quarterly dividend and a $60 billion share repurchase plan.[158]

Hedge fund activism to reduce cash reserves has often been criticized as myopic.[159] Greenlight's activism could, *prima facie*, be detrimental given the large scale of the reduction in cash reserves, the importance of innovation to Apple and the highly confrontational nature of the campaign. However, there has been no observable evidence that Greenlight's activism reduced Apple's value in any way. The reason behind this phenomenon is likely to lie in Apple's life stage.

It is often argued that companies with small or no cash reserves are unable to seize business opportunities when they arise or to absorb unanticipated negative shocks.[160] This argument is more valid for young companies. Young companies need large amounts of capital to develop products and to fuel growth.[161] Raising capital in the market is expensive for them because they are unfamiliar to the market. For example, Del Guercio found that mainstream institutional investors shied away from companies which did not have sufficient data for at least ten years.[162] Moreover, young companies have high levels of risk because they are experimenting with their products and strategies. Some of these attempts inevitably fail. As investors generally require risk premiums to invest in risky companies, raising capital in the market can be costly for young companies.[163] Raising capital externally is also slow. As they must be able to respond promptly to changes, retaining earnings becomes paramount

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[157] Ibid, 1.

[158] Apple Inc, Form 10-K (September 28, 2013), Accessed on April 13, 2019, at <https://www.sec.gov/Archives/edgar/data/320193/000119312513416534/d590790d10k.htm>, 26.

[159] Martin Lipton, Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy, Harvard Law School Forum on Corporate Governance and Financial Regulation, Accessed on April 13, 2019 at <https://corpgov.law.harvard.edu/2013/02/26/bite-the-apple-poison-the-apple-paralyze-the-company-wreck-the-economy/>.

[160] John Graham, "How Big Are the Tax Benefits of Debt" (2000) 55 Journal of Finance 1901, 1911.

[161] Robert Quinn and Kim Cameron, "Organizational Life Cycles and Shifting Criteria of Effectiveness: Some Preliminary Evidence" (1983) 29 Management Science 33, 40.

[162] Daniel Del Guercio, "The Distorting Effect of the Prudent-Man Laws on Institutional Equity Investments" (1996) 40 Journal of Financial Economics 31, 38.

[163] Dennis Mueller, "A Life Cycle Theory of the Firm" (1972) 20 The Journal of Industrial Economics 199, 200.

for young companies. Hedge fund activism to reduce their cash reserves simply to have higher payouts sacrifices long-term value for the sake of the short term and is therefore myopic.

The situation is quite different for mature companies, such as Apple. Apple has multiple product lines. Products such as iPhones, iPads, Macs and iTunes are finalized. Although Apple constantly introduces new versions, the core features of these products remain unchanged, as well as their production processes and retail systems. Also the demand for the products is stable. For example, sales of iPads in 2013 accounted for 19% of Apple's total sales. The percentage was 20% in 2012 and 18% in 2011.[164] Thus these products are mature products with relatively low levels of risk. Apple is also developing new products, which is risky. But because Apple's mature products are extremely successful, their large profits can compensate for any losses from failed new product development. For example, in 2013 Apple invested $4.5 billion in research and development.[165] If a company making $10 billion annually invests this amount in innovation, it will have a high level of risk. But Apple made $53.67 billion from operating activities in 2013.[166] Even a catastrophic failure in innovation is unlikely to alter Apple's risk level significantly. Therefore, Apple is a mature company with stable cash flows. Statistical evidence also supports this observation. Apple made $53.67 billion from operating activities in 2013 and $50.86 billion in 2012.[167] Operating expenses remained at 9% of total net sales.[168] As mature companies have low levels of risk, they should be able to predict quite accurately how much cash they need. Raising capital in the market is also much cheaper for them than for young companies. Thus there is no need for mature companies to retain earnings heavily. In fact, large cash reserves at mature companies might be the result of agency problems, as they insulate managers from market discipline.[169] Therefore, reduction of cash reserves is more beneficial to mature companies than young companies.

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[164] Apple, supra note 158, 28.
[165] Ibid, 7.
[166] Ibid, 35.
[167] Ibid.
[168] Ibid, 33.
[169] Michael Jensen, "Agency Costs of Free Cash Flow, Corporate Finance and Takeovers" (1986) 76 American Economic Review 323, 323.

Apple's case supports the hypothesis that shareholder activism is likely to be beneficial to mature companies. The rest of this section examines shareholder activism in Darden and HP to study its effect on declining companies.

3. Darden

Darden is an American restaurant operating company. It is famous for its seafood restaurant chain Red Lobster and Italian restaurant line Olive Garden. It also set up several specialty restaurants, such as Longhorn Steakhouse.[170] Over the years, new brands prospered while older brands' performance kept deteriorating.[171] Two hedge funds, Barington Capital and Jana Partners tried to address this problem but were unsuccessful.[172] They contacted Starboard, another hedge fund, which asked the company to separate older brands, including Red Lobster and Olive Garden from the younger brands.[173] Starboard justified this proposal on several grounds. First, as the older brands were more well-known than the younger brands, investors tended to overly link the company's value to the performance of the older brands without taking into full consideration the value of the younger brands. The underperformance of the older brands led to undervaluation of the younger brands and the whole company.[174] Having younger brands subsidize older brands also hid the real extent of problems faced by older brands and allowed executives to avoid criticism.[175] Second, the two sets of brands were at different life stages and had different goals. Younger brands were at the growth stage.[176] They needed to experiment with dishes and restaurant culture to find the most suitable strategy. Such experiments required large amounts of capital and had high levels of risk. Hence younger restaurants had unstable cash flows

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[170] https://www.darden.com/ Accessed on April 13, 2019.
[171] Owen Walker, *Barbarians in the Boardroom: Activist Investors and the Battle for Control of the World's Most Powerful Companies* (Pearson 2016), 45.
[172] Ibid, 50.
[173] Starboard Value: Transforming Darden Restaurants (September 11, 2014) Accessed on April 13, 2019 at < http://www.shareholderforum.com/dri/Library/20140911_Starboard-presentation.pdf>, 231.
[174] Ibid.
[175] William Bratton, "Hedge Funds and Governance Targets" (2007) 95 The Georgetown Law Journal 1375, 1393.
[176] Ibid, 232.

and had to reinvest a large portion of their earnings.[177] Older brands had already successfully established consumer bases. Their main goal was to retain them. As growth opportunities for older brands were limited, a large proportion of their earnings were expected to be returned to shareholders.[178] Separating the younger and the older brands would clarify their respective objectives, give investors with different investment preferences more options, give managers more focus and subject them to stronger corporate governance discipline.[179]

Starboard's proposal was rejected by the company. Shortly afterwards, the company started negotiations to sell Red Lobster. The deal was objected by Starboard. It believed that although Red Lobster's performance was declining, the brand remained strong. With loyal customers and feature dishes, it could be turned around.[180] The company's charter allowed shareholders holding more than 50% of outstanding shares to call general meetings. Starboard managed to secure support of 54% of shares and called a general meeting to discuss the Red Lobster deal.[181] But before the meeting was held, the company sold Red Lobster to Golden Lion, a private equity fund, for $2.1 billion. Starboard argued that the board sold Red Lobster too cheaply without seriously considering other alternatives. It calculated that Red Lobster's real estate alone was worth $2.1 billion if it was spun off as a tax-exempted REIT,[182] not to mention its brand value.[183] Starboard considered the sale a complete disregard of shareholder voice and launched a proxy fight to replace the whole board.[184]

Starboard also proposed a plan to turn around Olive Garden. The plan focused on

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[177] Toms, supra note 139, 351.
[178] Ibid, 357.
[179] Walker, supra note 171, 46.
[180] Starboard, supra note 173, 176.
[181] Jeff Morganteen, Starboard Wins Consent of 54% of Darden Shareholders for special MTG: Sources, CNBC (April 22, 2014).
[182] In the US, real estate investment trusts are companies whose main business is to hold and manage real estates. REITs are investment vehicles which allow investors who do not have the wealth to purchase real restates to profit from the housing market by trading their shares. Hence REITs are exempt from corporate taxes. To qualify as a REIT, more than 75% of its income must be generated from real estates and 90% of its profits must be distributed annually. 26 U.S.Code 856-858.
John Dawson, "The Real Estate Investment Trust" (1962) 40 Texas Law Review 886.
[183] Starboard, supra note 173, 37.
[184] Ibid, 49.

cost cutting. First, Olive Garden was renowned for its unlimited breadsticks service. Starboard found that each table was given a basket of free breadsticks, which often went to waste. Starboard suggested that one breadstick should be given to each customer, who could request for more.[185] Second, the menu should be simplified to save cost on supplies and staff.[186] Third, food preparations, such as cutting vegetables, should be outsourced.[187] Fourth, Olive Garden's microwave-safe takeaway boxes should be replaced with cheaper ones.[188] Finally, Olive Garden should change its advertising strategy from television and newspapers to social media, which is cheaper.[189] Starboard's activism was successful, as all twelve directors were replaced with Starboard's nominees. The turnaround plan was executed and Olive Garden was successfully revived.[190]

The turnaround of Olive Garden suggests that shareholder activism might be particularly beneficial to declining companies. As demand for their products decreases, declining companies have small or negative net income. To survive as going concerns, declining companies have no choice but to cut costs and sell non-core assets. These actions, collectively known as retrenchment,[191] give declining companies time and resources to develop long-term turnaround plans.[192] Successful turnarounds require correct identification of the causes of decline. External causes are market or industry wide. For example, the financial crisis reduced incomes of middle-class households which depressed Olive Garden's business.[193] Internal factors of decline include poor strategies, such as targeting a wrong group of consumers and poor operation, which refers to bad execution of good strategies.[194] If a company decides that its problem is strategic, it must develop new strategies. This often

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[185] Ibid, 105.
[186] Ibid, 114.
[187] Ibid, 115.
[188] Ibid, 111.
[189] Ibid, 130.
[190] Jon Markman, Dig into the Surprising Success of Darden Restaurants, Forbes (August 7, 2018)
[191] D Robbins and John Pearce, "Turnaround: Retrenchment and Recovery" (1992) 13 Strategic Management 287, 287.
[192] Shamsud Chowdhury, "Turnarounds: A Stage Theory Perspective" (2002) 19 Canadian Journal of Administrative Science 249, 255.
[193] Walker, supra note 171, 47.
[194] Robbins and Pearce, supra note 191, 288.

involves investments into its new strategic focuses, which requires the company to raise capital via further cost and asset reductions.[195] Excessive costs are also common causes for operational inefficiency. Thus retrenchment also plays an important role in long-term corporate turnarounds. As de-conglomeration and cost-cutting are common objectives of activist hedge funds, their expertise in retrenchment could be especially helpful to declining companies.

In the case of Olive Garden, although the financial crisis contributed to its decline, the fact that it significantly underperformed its peers[196] suggests that a large part of its problems were internal. Since the brand was still strong, the problems were mostly likely to be operational, which Starboard addressed by cutting costs. Some of Starboard's cost-cutting tactics appear to be myopic. Surely an abundance of breadsticks and a thick menu would elicit more positive feelings from customers. In the long term, food prepared from scratch and high quality takeaway boxes could be the reasons Olive Garden stand out from its peers. These arguments are certainly valid for non-declining companies. However, for Olive Garden, the key was not success in the long term, but survival in the immediate future. In this light Starboard's proposal seems highly practical. Since myopia is less of a concern, hedge fund activism would be particularly beneficial to declining companies.

Nevertheless, excessive myopia and retrenchment can still have detrimental effect on declining companies. Retrenchment must be carried out according to the company's strategy.[197] Olive Garden's strategy was to deliver authentic Italian food at affordable prices.[198] Starboard cut costs by removing dishes such as burgers and fries from the menu, outsourcing the preparation of soup and switching to cheaper takeaway boxes. None of these actions went against Olive Garden's strategy or destroyed its competitive advantage. In fact, Starboard pushed the strategy further by investing saved capital into development of more genuine Italian dishes.[199] In

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[195] Chowdhury, supra note 192, 255.
[196] Starboard, supra note 173, 25.
[197] Vincent Barker and Mark Mone, "Retrenchment: Cause of Turnaround or Consequences of Decline" (1994) 15 Strategic Management Journal 395, 397.
[198] Starboard, supra note 173, 162.
[199] Ibid, 189.

comparison, Motorola's strategy focused on innovation, which was directly harmed by Icahn's activism. As Motorola was in decline, the negative consequences of the activism were especially significant. Thus both the beneficial and detrimental effect of hedge fund activism are accentuated for declining companies. The turnaround of HP provides an approach to mitigate excessive myopia of activist shareholders.

4. HP

Hewlett-Packard had been on a declining path since the early 2000s. HP specialized in the manufacturing of personal computers, printers and servers. This traditional focus on hardware caused the company's slow response to the development of cloud technology. As a result, a growing number of its server buyers switched to more advanced cloud computating offered by companies such as Apple and Amazon. This was a heavy blow to HP as the sales of servers contributed a large part of its income.[200]

More importantly, HP's board was divided, which resulted in frequent boardroom coups and the company having had four CEOs in a decade.[201] This led to inconsistent strategies. For example, the strategy of Mark Hurd, the CEO from 2005 to 2010, was to maintain HP's competitive advantage in hardware.[202] His successor Leo Apotheker's view was to transform HP into a software company. Guided by this vision, in 2011 HP acquired Autonomy, a British software company, for more than $10 billion.[203] This transaction showed that the board was not only fragmented, but also ineffective. It later turned out that Autonomy committed accounting fraud to inflate its earnings and the board had approved the acquisition, which badly overvalued Autonomy, without due diligence.[204] Despite all of HP's problems, the

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[200] Barb Darrow, Meg Whitman and HP Five Years Later: Mission Accomplished? Fortune (September 27, 2016).
[201] Computer World, Timeline: Hewlett-Packard CEOS, Accessed on April 13, 2019 at <https://www.computerworld.com/article/2556393/timeline--hewlett-packard-ceos.html>.
[202] Quentin Hardy, Hewlett-Packard's Mark Hurd: He Wants it all, Forbes (March 25, 2010).
[203] Jane Croft, Former Hewlett-Packard Chief Defends Its Due Diligence on Autonomy, Financial Times (April 1, 2019).
[204] Ibid.

board showed no sign of addressing any of them, which prompted the activism of Relational Investors, a hedge fund based in San Diego.

Relational Investors signed an agreement with HP, according to which it agreed to remain in HP for at least two years, to keep its share ownership under 10% and not to seek for acquisitions of HP.[205] Afterwards, Whitworth, Relational's fund manager, was appointed to the board. He then reached out to other large HP shareholders. Together the shareholders supported the incumbent CEO Meg Whitman and removed several directors. The situation was quickly steadied.[206] Whitworth then worked with Whitman to design a turnaround plan. The objectives of the company were decided to be to keep its competitive position in hardware while catching up on the development of cloud technology. Accordingly, in 2014 the company was split into two entities, with HP Inc focusing on hardware and HP Enterprise focusing on the cloud.[207] To have more focus as well as to cover the loss of sales, other business was offloaded. For example, HP's software business, including Autonomy, was sold to Micro Focus in 2016.[208] The two entities also laid off a total of 85,000 employees to further reduce costs.[209] The turnaround was widely acknowledged as successful. HP Enterprise's share price nearly doubled its IPO price.[210] HP Inc, which was burdened with most of old HP's debt, also managed to rise. It utilized its experience and intellectual property in printing and made big progress in 3d printing.[211] Whitworth's role in the turnaround was appreciated as he was later elected chairman of the board.[212]

Standstill agreements are common in cases of hedge fund activism. Most companies use standstill agreements to prevent hedge funds from further activism.[213]

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[205] Walker, supra note 171, 162.
[206] Ibid.
[207] Salvador Rodriguez, Hewlett-Packard Enterprise to Complete Software Spinoff, Reuters (September 1, 2017).
[208] Mathew Field, Micro Focus Begins to Recover after Disastrous HP Enterprise Deal, The Telegraph (February 14, 2019).
[209] Darrow, supra note 200.
[210] Ibid.
[211] Rob Enderle, As New Turnaround King, Is HP Better than Apple? Tech Buzz (August 28, 2017).
[212] Walker, supra note 171, 165.
[213] For example, Rolls Royce granted Value Act one board seat while Value Act promised not to campaign for the breaking up of the company and not to acquire more than 12.5% of the shares.
See Peggy Hollinger, Rolls Royce Agrees Value Act Board Deal, Financial Times (March 2, 2016).
ValueAct also had a standstill agreement with Microsoft. It promised not to acquire more shares or

But standstill agreements can do more that. In the case of HP, by agreeing to be locked in the company for two years, Relational Investors signaled its commitment to the long term, which won it support from other shareholders. The support of Relational Investors also relieved the company from market pressure to some extent and gave it more time for turnaround. As the detrimental effect of myopic activism is accentuated for innovative and declining companies, standstill agreements would be particularly useful to them.

VI. Organizational Structure

1. Overview

One of the most common goals of hedge fund activism is to break up conglomerates.[214] This is usually done through spinoffs, which is offering the company's shares in the subsidiary to public investors.[215] Other techniques to deconglomerate include selling the subsidiary to another company and carve-outs. In a carve-out transaction, the company offers its shareholders the choice between holding shares in the carved out subsidiary or shares in the remaining business.[216] Hedge fund activism to deconglomerate has often been criticized as myopic.[217] The belief is that in order to make quick returns, hedge funds push for the divesture of subsidiaries whose combination with the rest of the business is beneficial. The divestures would reduce the company's value in the long term and might attract further activism to divest. As a result, a perfectly viable business is dismembered,

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launch proxy fights in exchange for one directorship.
See Richard Walters, Microsoft Cedes Board Seat to ValueAct, Financial Times (August 30, 2013).

[214] For example, Bratton found that 32% of hedge fund activism cases had spinoff as one of their objectives.
See William Bratton, "Hedge Funds and Governance Targets" (2007) 95 Georgetown Law Journal 1375, 1393.

[215] David Stowell, *An Introduction to Investment Banks, Hedge Funds and Private Equity* (2010 Elsevier), 76.

[216] Ibid, 75.

[217] Steve Denning, The Seven Deadly Sins of Activist Hedge Funds, Forbes (February 15, 2015).

which is why sometimes hedge funds are parallel to corporate raiders in the 1980s.[218] Icahn's activism in Motorola illustrates this detrimental aspect of hedge fund activism. But hedge fund activism to divest would be beneficial to companies where business combinations are inefficient.

Academic literature has long questioned the efficiency of conglomerates. On the bright side, vertical integration solves the incomplete contracting problem.[219] Integration also creates internal capital markets, where resources might be allocated more efficiently than in the external market.[220] Imagine a conglomerate that has two divisions, a cash cow, which has few growth opportunities and generates more cash than it needs,[221] and an innovative division with no income and large capital requirements. If the innovative division was independent, its high risk would make raising capital difficult.[222] But within the conglomerate, its innovation could be supported by the surplus of the cash cow.

However, the internal capital market theory is not always supported by empirical studies. For example, Scharfstein found that within conglomerates, divisions with good prospects have fewer resources than their independent peers while divisions with poor prospects receive more funding.[223] Researchers have offered several explanations for this phenomenon. First, even genuinely honest managers make mistakes and the larger the conglomerate gets, the more difficult it becomes to allocate resources efficiently. Second, an independent entity chooses projects based on their net present value. But to have more resources, a conglomerate division must also consider whether the project appears to be better than other divisions' projects. This often results in divisional managers forgoing projects with high levels of risk or

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[218] Aaran Fronda, The Rebranding of Corporate Raiders, World Finance (March 9, 2016).
[219] See Chapter 3.
[220] Raghuram Rajan, Henri Servaes and Luigi Zingales, "The Cost of Diversity: The Diversification Discount and Inefficient Investment" (2000) The Journal of Finance 35, 36.
[221] Henderson, supra note 135, 37.
[222] Dennis Mueller, "A Life Cycle Theory of the Firm" (1972) 20 The Journal of Industrial Economics 199, 200.
[223] David Scharfstein, The Dark Side of Internal Capital Markets II: Evidence from Diversified Conglomerates, NBER Working Paper 6352 (1998) Accessed on April 15, 2019, at <https://www.nber.org/papers/w6352>, 3

which take several years to pay off.[224] Third, as remuneration for general managers and divisional managers are both accounted as SG&A[225] expenses, reducing divisional managers' remuneration can strengthen the company's cash flow and increase the amounts payable to general managers. To compensate divisional managers, general managers award their divisions more resources, because larger divisions translate into more sense of power and more non-pecuniary benefits.[226] general managers might share this desire for large size. In that case, conglomerates are results of managerial empire-building,[227] not efficient combinations of business entities.

Darden's case suggests that conglomerates whose subsidiaries are at different life stages are more likely to be inefficient. The next two parts explore this hypothesis further and examine hedge fund activism's effect on these conglomerates.

2. EBay

In 2014, Icahn Enterprise launched a proxy fight in eBay to nominate two directors and to spin off PayPal, Ebay's online payment division.[228] Icahn outlined its rationale in its public letters to Ebay's shareholders. It accused the two directors it intended to replace, Scott Cook and Marc Andreessen, of having conflicts of interest, especially Andreessen who managed the venture capital firm Andreessen Horowitz. Andreessen served on several corporate boards, including eBay's competitor Silver Lake, which purchased Skype, a video chatting software, from eBay in 2009. Icahn considered the fact that Silver Lake was able to purchase Skype for $2.75 billion and sold it to Microsoft for $8.5 billion shortly afterwards evidence that Andreessen's

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[224] Rajan et al, supra note 220, 69.
[225] Sales, General and Administrative.
[226] David Scharfstein and Jeremy Stein, "The Dark Side of Internal Capital Markets: Divisional Rent-Seeking and Inefficient Investment" (2000) The Journal of Finance 2537, 3548.
[227] John Coffee, "Shareholders versus Managers: The Strain in the Corporate Web" (1986) 85 Michigan Law Review 1, 20.
[228] Carl Icahn's letter to eBay Stockholders, Accessed on Aug 26, 2018 at https://www.sec.gov/Archives/edgar/data/921669/000092846414000016/ebaydfan14a022414.htm.

conflicts of interest prevented him from discharging his duties to eBay.[229] Meanwhile, eBay insisted that Andreessen was excused from decision-making on the sale of Skype.[230]

Although eBay adamantly refused Icahn's request at first, it eventually reached an agreement with Icahn according to which Icahn aborted the proxy fight. PayPal was spun off later that year. Andreessen also resigned from eBay's board.[231] Whether Icahn was right about Andreessen was unclear. It is not uncommon for managers of venture capital funds to remain on the board of their investee companies after they go public. Empirical studies have even found that newly listed companies with venture capital funds on the board had better corporate governance, in the form of more independent boards and less earnings management, than companies without the presence of venture capital funds.[232] This suggests that venture capitalist firms, with their expertise in young companies, continue to be helpful to companies going through the private-to-public transition.[233] However, this beneficial effect might fade as companies grow, as in the case of eBay, which went public in 1998.[234] Since venture capitalist firms invest in a large number of companies, their conflicts of interest indeed is a concern. Whether and to what extent the Skype transaction was affected by Andreessen's conflicts of interest cannot be said for certain without further information.

With regard to PayPal, the answer is more certain. On September 30, 2014, the day PayPal went public, its price closed at $40.37, while eBay's closing price was $28.57. The day before the split, eBay traded at $66.29, which was less than the aggregate market capitalization of the two entities.[235] This showed that PayPal was

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[229] Ibid.
[230] EBay Responds to Carl Ichan's Open Letter to Stockholders, Accessed on Aug 26, 2018 at <https://www.ebayinc.com/stories/news/ebay-inc-responds-carl-icahns-feb-24-open-letter-stockholders/>.
[231] Ryan Mac, Marc Andreessen Resigns from eBay Board following Carl Icahn, Forbes (October 20, 2014).
[232] Yael Hochberg, "Venture Capital and Corporate Governance in the Newly Public Firm" (2011) 15 Review of Finance 1, 9.
[233] Ibid.
[234] EBay, Our History, Accessed on April 15, 2019 at <https://www.ebayinc.com/our-company/our-history/>.
[235] Manuel Castel-Branco, Carl Icahn Pushes eBay to Spinoff PayPal (MA Dissertation, Nova School

undervalued as a part of eBay. Since eBay's share price before the spinoff was inflated by the prospect of PayPal's public offering, the actual undervaluation of PayPal and the value the spinoff unlocked was even greater.[236]

The positive effect of the activism could be explained by the different life stages of EBay and PayPal. In 2002, eBay needed an online payment system of its own to facilitate online transactions and acquired PayPal. The combination of eBay and PayPal created significant synergies as eBay introduced PayPal, which was then little known to the market, to its large client base. However, the synergies faded after most users of eBay became PayPal users.[237] The combination started to create more costs than benefits as eBay and PayPal reached different stages of life. In 2013, PayPal grew by 22% while eBay's growth rate was 8%.[238] This shows that PayPal remained a growing company while eBay was approaching maturity. Different life stages mean different objectives. For PayPal, there were still many opportunities to explore. In 2011, PayPal announced that its new goal was to make PayPal a payment method at ordinary stores, replacing cash and credit cards. This was a challenging goal especially after Google and Apple joined the race by introducing their digital payment methods.[239] Hence PayPal should make little shareholder payouts and reserve most of its earnings for growth. Meanwhile, the goal of eBay should be to maintain its competitive edge, particularly against its main competitor, Amazon. This was not an easy task either, as eBay lacked Amazon's level of integration and had to compete against the benefits Amazon brought with its own logistic and storage systems.[240] Since eBay's business model was largely set, a large part of its earnings ought to be returned to shareholders. The combination of entities with divergent objectives made managers less focused and blurred each entity's objectives. EBay's lackluster performance got improved by counting into PayPal's performance while PayPal was

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of Business and Economics, 2016), 29.

[236] Ibid.

[237] David Yoffie and Eric Baldwin, eBay vs Carl Icahn, 2014, Harvard Business Review (August 10, 2016).

[238] Castel-Branco, supra note 235, 12.

[239] Steven Bertoni, Ebay and PayPal to Split: Carl Icahn and Elon Musk Wish Comes True, Forbes (September 30, 2014).

[240] The Economist, EBay and PayPal: Better off Alone (July 18, 2015).

undervalued, operating under the shadow of eBay and its problems. PayPal's spinoff was beneficial as it not only allowed the two entities to focus, but also allowed investors to evaluate and monitor the two entities more effectively.[241]

However, business life stage is not the only factor influencing the efficiency of conglomerates and hedge fund activism. Another factor is the level of synergies between relevant business divisions, as the case of Timken illustrates.

3. Timken

Timken was an American company producing specialized steel and bearings, which are mechanical elements used to reduce friction. In 2012, Relational Investors and CalSTRS[242] made a joint proposal to the company to spin off its steel division.[243] The proposal was approved by 53% of the company's outstanding shares and the steel division was spun off as TimkenSteel.[244]

Relational and CalSTRS used a corporate life stage argument to justify the separation. They argued that the steel division was at the growing stage while the bearing division was mature.[245] The separation would give each division more focus, allow investors to value them more correctly and subject managers to stronger corporate governance discipline.[246] The company argued that there were significant synergies between the two divisions which would be lost in the separation.[247]

Synergies refer to benefits created or costs saved by the combination of entities

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[241] Icahn, supra note 228.
[242] California State Teachers' Retirement System.
[243] Relational Investors and CalSTRS, The Timken Company: Why the Separation of Timken's Bearings and Steel Business can Unlock Significant Shareholder Value (March 1, 2013) Accessed on April 15, 2019 at <https://www.10xebitda.com/wp-content/uploads/2016/11/Relational-Investors-Timken-Presentation-Mar-2013.pdf>, 6.
[244] Tess Stynes, Timken Vote Backs Steel Spinoff, The Wall Street Journal (May 7, 2013).
[245] Steve Denning, When Pension Funds Become Vampires, Forbes (December 10, 2014).
[246] Anna Prior, Timken's Steel Business to Start Trading Tuesday, The Wall Street Journal (July 1, 2014).
[247] Relational and CalSTRS' Response to Timken's Misleading Analysis, Accessed on April 15, 2019 at <https://www.sec.gov/Archives/edgar/data/98362/000110465913029264/a13-10050_1px14a6g.htm>, 9.

which cannot be achieved if the entities are independent.[248] Generally synergies arise from the sharing of resources. In the case of Timken, the bearing and the steel division saved costs by sharing infrastructures, such as storage and IT systems.[249] The two divisions also shared knowledge. The bearing division had various manufacturing companies as clients and had better knowledge on what types of steel the market needed than the steel division. Meanwhile, the steel division had deep knowledge on the features of each type of steel and how to put it to better use. Exchange of knowledge created value for both divisions.[250] Combination of the two divisions also allowed the bearing division to control the quality, price and timing of its steel supplies.[251]

Relational and CalSTRS argued that the synergies between the two divisions were not as significant as the management claimed. Only 10% of Timken's bearings used its steel. Hence the benefits of supplies control were limited.[252] Synergies from the sharing of tangible assets could be easily replicated by cooperating independent entities. Relational and CalSTRS believed that synergies from knowledge sharing could also be maintained by having constant communication channels between independent entities.[253] But synergies from knowledge sharing could not be replicated if it requires background knowledge and familiarity between communicating parties.[254] On the other hand, employees have to devote effort to maintain that level of familiarity, which might make them distracted and less productive.[255] Thus the issue is whether the benefits of synergies outweigh the costs. Without further information, this question cannot be answered for Timken.

But application of the internal market theory suggests that shareholder activism in Timken was indeed myopic. The steel industry is a cyclical industry. Steel price

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[248] Aswath Damodaran, Damodaran on Valuation: Security Analysis for Investment and Corporate Finance (2006, 2 edn, Wiley), 541.
[249] Relational and CalSTRS, supra note 247, 9.
[250] Denning, supra note 245.
[251] Relational and CalSTRS, supra note 247, 9.
[252] Relational and CalSTRS, supra note 243, 35.
[253] Relational and CalSTRS, supra note 247, 9.
[254] Morten Hansen, "Knowledge Networks: Explaining Effective Knowledge Sharing in Multiunit Companies" (2002) 13 Organization Science 232, 235.
[255] Ibid.

depends on various factors, such as the upturns and downturns of the construction industry and the price of other metals like aluminum.[256] One motivation behind Relational and CalSTRS activism was to insulate the bearing division from the volatility of the steel division, so that more risk-seeking investors could invest in the steel division while more risk-averse investors could invest in the bearing division.[257] The combination of the two divisions made the company less attractive to both groups of investors. Relational and CalSTRS argued that there was no need for Timken to diversify, because shareholders could diversify themselves. This is true for many companies, but not for Timken. Timken manufactured specialized steel, which was innovative and required large R&D expenditure. Timken's steel division was much smaller than its competitors. In market downturns, it was unlikely to be able to support its innovation and needed to be subsidized by the bearing division. Separating the two divisions was detrimental as it destroyed the steel division's innovative capacity.[258]

The role played by CalSTRS is also worth analyzing. Other than being fellow shareholders in Timken, CalSTRS was also an investor in Relational.[259] It is the contention of this thesis that since different institutional shareholders have different private benefits, self-interested activism can be mitigated by encouraging institutional shareholders to vote on activism more responsibly. But institutional shareholders with interests in activist shareholders cannot be expected to vote purely on the merits of activism.[260] As will be argued in the next chapter, this thesis proposes that institutional investors should disclose periodically their portfolios and investment activities. This would allow investors and public authorities to review *ex post* whether their votes on shareholder activism were based on private benefits. Institutional investors can punish self-interested funds by withholding support in other companies.

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[256] Craig Gallet, "Cyclical Fluctuations and Coordination in the US Steel Industry" (1997) 29 Applied Economics 279, 280.
[257] Relational and CalSTRS' Response to Timken's, .9
[258] Nelson Schwartz, How Wall Street Bent Steel, The New York Times (December 6, 2014).
[259] Steve Denning, When Pension Funds Become Vampires, Forbes (December 10, 2014).
[260] Ronald Gilson and Jeffrey Gordon, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2206391> Accessed on June 19, 2017.

VII. Conclusion

The previous chapter reviewed theoretical and empirical studies on the advantages and disadvantages of institutional shareholders activism. It finds that firm-specific factors influencing the efficiency of shareholder activism have not been recognized by existing studies. This chapter conducts case studies to fill this gap. It finds evidence that shareholder activism is more beneficial to companies operating in less competitive product markets, to mature companies and inefficient conglomerates. Both the beneficial and detrimental effect of shareholder activism is accentuated for innovative companies and declining companies. The question that logically follows is whether institutional shareholders have incentives to initiate activism which is tailored to specific companies and to vote on activism based on firm-specific factors. Chapter 6 explores legal rules which might discourage institutional shareholders from doing so.

Chapter 6 Legal Obstacles to Institutional Shareholder Activism

The previous chapter showed that shareholder activism is only efficient when shareholders take firm-specific factors into consideration, which is costly. The next logic step is to ascertain whether institutional investors have incentives to consider firm-specific factors. This chapter examines how and to what extent legal rules in the US and the UK might discourage shareholder activism and whether there is need to reform parts of the existing framework to encourage efficient shareholder activism.

Section I examines diversification rules. Section II studies rules pertaining to mandatory disclosure of large shareholdings. Section III looks at rules impeding shareholder cooperation. Section IV discusses insider trading and Section V analyzes control person liability. Section VI concludes.

I. Diversification Rules

Institutional shareholders only have incentives to engage in activism when their benefits from activism outweigh the costs. As most benefits are proportionate to activist shareholders' stakes in the company, legal rules limiting their shareholdings might discourage activism.

1. US

In the US, trustees of public pension funds are governed by the common law of trust. *Harvard College v Amory* established the prudent person rule, which requires those who manage the assets of others to exercise the same level of prudence as they would manage their own assets.[1] Under this rule, whether an investment is prudent is evaluated independently. Taking a large position in a company is risky and imprudent *per se*.[2] The prudent person rule was challenged by the portfolio theory.

[1] Harvard College v Amory 26 Mass. (9 Pick) at 461.
[2] Martin Begleiter, "Does the Prudent Investor Need the Uniform Prudent Investor Act: An Empirical

The portfolio theory posits that each investment has specific risk and systematic risk.[3] Take investing in an automobile company for an example. The risk that the company's new model would not be welcomed by consumers is specific to the company. Risks such as rising steel and tires prices are market-wide. The portfolio theory argues that a portfolio can be structured to offset each investment's specific risk.[4] Hence no investment is imprudent *per se*. It all depends on its position in the portfolio.

Gradually, the portfolio theory is recognized in law. The Third Restatement of Trust replaced the prudent person rule with the prudent investor rule. The Employee Retirement Income Security Act of 1974, which governs private pension funds, also adopts the prudent investor rule.[5] Instead of judging an investment in isolation, the prudent investor rule equates prudence to diversification.[6] General consensus is that diversification can be achieved by investing in 20-30 companies.[7] But most pension funds are excessively diversified. For example, Wong found that the largest funds invest in more than 15,000 companies.[8] This results in them having relatively small shareholdings[9] and weak incentives to engage in activism.

Mutual funds are governed by the Investment Company Act of 1940. The Act does not pose limits on mutual funds' shareholdings. But mutual funds are subject to triple taxation. After its investee company pays taxes on its income, the mutual fund has to pay taxes on the dividends and capital gains it receives. Investors in the mutual fund also need to pay taxes on their investment returns.[10] To be exempt from triple taxation, mutual funds must diversify 75% of their assets. This means that mutual funds cannot hold more than 10% of one company's shares or hold shares in one

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Study of Trust Investment Practices" (1999) 51 Maine Law Review 27, 32.

[3] Ibid, 33.

[4] Paul Haskell, "The Prudent Person Rule for Trustee Investment and Modern Portfolio Theory" (1990) 69 North Carolina Law Review 87, 101.

[5] The Employee Retirement Income Security Act of 1974, codified at 29 U.S.C. Ch 18 .

29 U.S.C. §1104.

[6] The American Law Institute, Third Restatement of Trust §227.

[7] Terry Smith, Too Many Stocks Spoil the Portfolio, Financial Times (April 12, 2013).

[8] Simon Wong, 'Is Institutional Investor Stewardship Still Elusive?" (2015) Butterworths Journal of International Banking and Financial Law 508, 508.

[9] Ashby Monk, The Prudent Person is a Bad Investor, Institutional Investor (June 26, 2014).

[10] Mark Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton University Press, 1994), 107.

company whose value is more than 5% of the fund's assets.[11] Excessive diversification is also present with mutual funds.[12]

Insurance companies are governed by insurance law of the State where their insurance policies are marketed. New York, the leading State in insurance regulation, prohibits insurance companies from investing more than 2% of their assets in equities of one issuer. Insurance companies' aggregated investments in equities cannot exceed 20% of their assets.[13] Such quantitative restrictions result in the general passivity of insurance companies as shareholders

Hedge funds are exempt from the Investment Company Act of 1940 if they do not offer securities to the public. This can be achieved by having fewer than 100 clients[14] or only qualified purchasers.[15] Qualified purchasers are individuals who own more than $5 million or entities which have more than $25 million in assets.[16]

Fund managers are governed by the Investment Advisers Act of 1940 and must register with the SEC.[17] They are required to disclose annually, on Form ADV, the value of assets under management, investment policies and fee structures.[18] Originally, hedge fund managers were exempt from the Act as long as they had fewer than 15 clients.[19] In 2003, the SEC tried to tighten hedge fund regulation by changing how the number of clients was calculated. Previously, a fund which has invested in a hedge fund was counted as one client. Under the proposed rule, that fund's clients would be counted as the hedge fund's clients. Thus this rule would subject most hedge funds and their fund managers to regulation.[20] The rule was quashed by the DC

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[11] The Investment Company Act of 1940, codified at 15 U.S.C. §80a-1 through §80a-64.
15 U.S.C. § 80a-5(b)(1).
[12] Wong, supra note 8, 508.
[13] New York Insurance Law, ISC § 1405(a)(6).
[14] 15 U.S.C. § 80a-3(c)(1).
[15] 15 U.S.C. § 80a-3(c)(7).
[16] 15 U.S.C. § 80a-2(a)(51).
[17] The Investment Advisers Act of 1940, codified at 15 U.S.C. § 80b-1 through § 80b-21.
15 U.S.C. § 80b-3(a).
[18] SEC Rules and Regulations under the Investment Advisers Act of 1940, codified at 17 CFR Part 275.
17 CFR § 275.204.
[19] 15 U.S.C. § 80b-3(b)(3).
[20] Eun Jip Kim, Rethinking Hedge Fund Regulation: Focusing on the US, the UK and Korea, Accessed on June 2, 2019 at
<https://www.repository.law.indiana.edu/cgi/viewcontent.cgi?article=1002&context=etd>, 90.

Circuit in 2006 on the grounds of *ultra vires* rule-making on the part of the SEC.[21]

Although hedge funds were not the main cause behind the subprime mortgage crisis, both the US and the UK responded by strengthening hedge fund regulation.[22] In the US, the fewer than 15 clients exemption was replaced by a size-based rule. Fund managers managing more than $100 million are now mandated to register with the SEC. Fund managers managing more than $25 million but less than $100 million are required to register with State regulators. Fund managers managing less than 25 million are exempt from regulation.[23] But the regulation does not restrict hedge funds' investment power.

2. UK

In the UK, pension funds are regulated by the Pension Regulator under the Pensions Act 2004.[24] Trustees of pension funds are also subject to the Pensions Act 1995 and the common law of trust, both of which prescribe a duty to diversify.[25]

Open-ended funds and their fund managers must be authorized by the FCA.[26] Implementing the Undertakings for Collective Investment in Transferrable Securities Directive,[27] UCITS in the UK are not allowed to invest more than 5% of their assets into one company[28] or hold more than 10% of one company's shares.[29] Excessive

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[21] Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006) at 883.
[22] Ellis Ferran, "After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU" (2011) 12 European Business Organization Law Review 379, 389.
[23] 17 C.F.R. § 275.203a-1.
[24] Pensions Act 2004, section 1.
[25] Trustee Act 2000, section 4(3)(b).
Pensions Act 1995, section 36(2).
[26] Open-ended funds include Open-ended Investment Companies (OEIC), Authorized Unit Trust (AUT) and Authorized Contractual Scheme (ACS).
The Open-Ended Investment Companies Regulations 2001, Regulation 12.
Financial Services and Markets Act 2000, section 242 and section 261C.
[27] Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions [2014] OJ L257/186.
[28] FCA Handbook, Collective Investment Scheme (COLL) 5.2.11.R.
[29] UCIT Directive, supra note 27, Article 52.
COLL 5.2.11.
COLL 5.2.29.

diversification is a problem for pension funds and mutual funds in the UK.[30]

With regard to insurance companies, Solvency II[31] came into effect in the EU in 2016. Member states have until 2032 to fully implement the Directive. Solvency II adopts the prudent person rule, requiring insurance companies to only invest in assets whose risks can be properly identified and managed. This would discourage insurance companies against large shareholdings.

The UK implemented the Alternative Investment Fund Managers Directive[32] and requires both hedge funds and their fund managers to be authorized by the FCA.[33] But regulation focuses mainly on disclosure and the funds' self-regulation without restricting the funds' investment power.[34]

3. Rationale

Certain level of mandated diversification is well justified. Most end investors in pension funds, mutual funds and insurance companies have limited expertise and wealth to realize and to bear losses from excessive risk-taking. Hence the law protects end investors by mandating diversification of the funds. Meanwhile, end investors of hedge funds are more capable of controlling the funds' risk-taking. The main objective in hedge fund regulation is not to protect end investors, but to ensure market stability.[35] This explains why regulation does not interfere with hedge funds' investment power.

However, diversification rules are too restrictive. Limiting how many assets funds can invest in one company would be enough to control their risk-taking. There

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[30] David Boss, Brian Connelly, Robert Hoskisson and Laszio Tihanyi, "Corporate Governance: Ownership Interests, Incentives and Conflicts" in Mike Wright, Donald Siegel, Kevin Keasey and Igor Filatotchev (eds) *The Oxford Handbook of Corporate Governance* (OUP, 2013), 254.

[31] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) [2009] OJ L335/1.

[32] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 [2011] OJ L 174/1.

[33] FCA Hand Investment Funds Sourcebook (FUND), 1.1.1 and 3.1.1.

[34] Kim, supra note 20, 136.

[35] Ferran, supra note 22, 382.

is no need to restrict funds' positions in one company. As Roe argued, such restriction is more likely to be motivated by the fear of institutional power.[36] The duty to diversify itself does not limit the size of shareholdings. This raises the question why pension funds fulfill this duty by diversifying excessively. One explanation is that diversification rules on mutual funds give pension funds the wrong impression that they also have to limit their shareholdings. Another possibility is that given their economic disincentives,[37] pension funds choose small shareholdings and the ease to exit over shareholder activism. The relative passivity of mutual funds supports this view. In 2014, BlackRock, one of the largest mutual funds in the US, had $3.7 trillion under management. Pershing Square, an activist hedge fund, had only $12 billion.[38] Even when 75% of BlackRock's assets must be diversified, it still had sufficient assets to invest in large shareholdings which would justify shareholder activism.[39] Its choice to diversify excessively instead suggests that although the diversification rules are overly restrictive, they are not main disincentives against institutional shareholder activism.

II. Mandatory Disclosure of Large Share Ownership

1. US

In the US, those who have beneficial ownership of more than 5% of the company's voting shares and intending to acquire or influence corporate control must file a Schedule 13D report with the SEC within ten days of crossing the threshold.[40] Intentions for acquiring the shares must be disclosed.[41] Increase or decrease by more than 1% must be subsequently disclosed until their share ownership drops below the

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[36] Roe, supra note 10, 69.
[37] See Chapter 1.
[38] Edward Rock, Institutional Investors in Corporate Governance, Accessed on June 2, 2019 at <https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=2459&context=faculty_scholarship>.
[39] Ibid.
[40] SEC Rules and Regulations under Securities Exchange Act of 1934, codified at 17 CFR Part 240. 17 CFR § 240. 13d-1(a).
[41] 17 CFR § 240. 13d-101.

5% threshold.[42]

Those who beneficially own more than 5% of the company's voting shares passively are required to file a Schedule 13G report with the SEC within 45 days after the end of the calendar year.[43] The purpose for acquiring the shares is not required to be disclosed.[44] Changes to their share ownership must be disclosed annually within 45 days after the end of the calendar year until their share ownership drops below the 5% threshold.[45]

Fund managers having more than $100 million under management must file a Form 13F report with the SEC within 45 days after the end of each calendar quarter, disclosing the funds' positions and their value.[46] Mutual funds are required to disclose their portfolios within 60 days after the end of each calendar quarter.[47]

Short positions are not required to be disclosed.[48] But Schedule 13D and 13G reports cover securities derivatives which give their holders voting or investment power over the underlying shares, as well as securities derivatives which allow their holders to acquire the shares within 60 days.[49] Recent years have seen an increase in the use of equity swaps by hedge funds to avoid share ownership disclosure.[50] Two assets are referenced in a total return swap, a loan and a certain number of shares. The long party of the swap pays the short party when the share value depreciates and pays interest on the loan. The short party pays the long party when the share value appreciates.[51] Rather than using the loan to purchase the shares, the swap allows the long party to profit from the shares without acquiring their ownership. It also allows

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[42] 17 CFR § 240. 13d-2(a).
[43] 17 CFR § 240. 13d-1(b).
[44] 17 CFR § 240. 13d-102.
[45] 17 CFR § 240. 13d-2(b).
[46] 17 CFR § 240. 13f-1.
[47] SEC Rule on Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, RIN 3235-AG64.
[48] SEC Short Sale Position and Transaction Reporting (June 5, 2014), Accessed on August 24, 2019 at < https://www.sec.gov/files/short-sale-position-and-transaction-reporting,0.pdf >, at 115.
[49] 17 CFR § 240. 13d-3.
[50] Henry Hu and Bernard Black, "The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership" (2006) 79 Southern California Law Review 811, 848-849.
[51] Daniel Bertaccini, "To Disclose of not to Disclose-CSX Corp, Total Return Swaps and Their Implications for Schedule 13D Filing Purposes" (2009) 31 Cardozo Law Review 267, 275.

the short party to receive interest on the loan without lending out the money.[52] But the bet increases risks and returns for both parties. The short party usually hedges its positions by holding an equal number of referenced shares.[53] As the shares are often purchased by the long party when the swap is terminated, the long party might be able to influence the short party on how to vote the shares.[54] This raises the question whether the long party should disclose their interests in the swaps.

In 2007, two hedge funds, the Children's Investment Fund and 3G Capital launched a proxy fight at CSX. The hedge funds had entered into total return swaps with a number of investment banks, all of which held shares in CSX.[55] CSX argued that the hedge funds had beneficial ownership of the banks' shares. As the aggregation of the shares exceeded 5%, the hedge funds violated Schedule 13D, based on which CSX sought an injunction to prevent the voting of these shares.[56]

The court reasoned that whether the hedge funds were beneficial owners of the banks' shares depended on whether they had control over the shares.[57] The court distinguished between two types of equity swaps. At the termination of a swap settled in kind, the short party is obligated to sell the shares to the long party at market price. But a short party in a cash-settled swap is under no such obligation. It also has no obligation to buy the shares.[58] Thus long parties in swaps settled in kind are beneficial owners of the shares *per se*. Whether long parties in cash-settled swaps own the shares must be subject to further examination.[59]

In the case of CSX, the swaps between the hedge funds and the banks were cash-settled swaps.[60] CSX argued that the hedge funds only entered into swaps with investment banks which they knew would vote following their instructions.[61] The court acknowledged that the investment banks might be sympathetic to the hedge

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[52] Ibid, 278.
[53] CSX Corp v The Children's Investment Fund Management 08-2899-cv, Judge Newman, 7.
[54] Hu and Black, supra note 50, 873.
[55] CSX v TCI, supra note 53, 8.
[56] Ibid, 11.
[57] Ibid, Judge Winter 23.
[58] Ibid, 20.
[59] Ibid, 2.
[60] Ibid.
[61] Ibid, 31.

funds' preference. But absent any voting agreements, the investment banks were free to vote as they please.[62] Thus the court ruled that the hedge funds did not control and were not beneficial owners of the shares held by the investment banks.

2. UK

Following the Transparency Directive, the UK requires shareholders holding more than 3% of a listed company's shares to notify the company within 4 days after crossing the threshold. The purpose for the acquisition of the shares is not required to be disclosed.[63] Increase or decrease by more than 1% must be subsequently disclosed until their share ownership drops below the threshold.[64] The company is required to publicize the information within one day of receiving the notification.[65] The disclosure rule applies to securities derivatives whose value depends on the company's share value, including equity swaps, which are called contracts for difference in the UK.[66] Following the EU Short Selling Regulation,[67] the UK adopts a two-tier reporting system for short positions. Investors whose net short positions exceed 0.2% of the company's issued share capital must notify the company within the next trading day.[68] Investors whose net short positions exceed 0.5% of the company's issued share capital must publicly disclose their positions within the next trading day.[69] Changes by 0.1% must be notified.[70] FCA authorized funds and fund

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[62] Ibid.

[63] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC [2004] OJ L390/38, Article 12(2).

FCA Handbook, Disclosure and Transparency Rules (DTR) 5.8.3.

[64] The Transparency Directive, Article 9(2); DTR 5.1.2.

[65] The Transparency Directive, Article 12; DTR 8.12.

[66] The Transparency Directive, Article 13(1); DTR 5.3.1.

[67] Council Regulation (EU) 236/2012 of the European Parliament and of the Council of 14 Mar. 2012 on Short Selling and Certain Aspects of Credit Default Swaps [2012] OJ L86/1.

[68] Ibid, Article 5.

[69] Ibid, Article 6.

[70] FCA, Notification and Disclosure of Net Short Positions (May 13, 2016), Accessed on September 16, 2019 at <https://www.fca.org.uk/markets/short-selling/notification-and-disclosure-net-short-positions>.

managers must disclose half-yearly their portfolios and investment activities.[71]

3. Rationale

There are several justifications for mandatory disclosure of large positions. First, large shareholdings affect corporate value. Monitoring by large shareholders can mitigate the agency problem. But large shareholders might also transfer value from small shareholders to themselves. Disclosure of large shareholdings allows investors to balance the costs and benefits brought by large shareholders.[72] Second, large shareholdings affect the value of voting rights. In a company with dispersed share ownership, shareholders know that voting outcomes are largely controlled by the management and would attach little value to their voting rights. The existence of large shareholders increases the possibility of voting contests and the value of shareholders' voting rights.[73] When large shareholders have control of the company, small shareholders would again consider themselves non-pivotal voters and discount their voting rights. Disclosure of major shareholdings allows investors to value their voting rights on a more informed basis. Third, most investors acquire or short-sell large amounts of shares because they have non-public information on the company. Disclosure of their positions might alert the market of the information and improve market efficiency.[74]

The current disclosure regime in the US has attracted much controversy. On the one hand, commentators such as Hu and Black argued that the disclosure regime is not broad enough.[75] Currently Schedule 13D, 13G and 13F do not require disclosure of short positions. They only require disclosure of certain kinds of securities derivatives. Mutual funds are mandated to disclose short positions and holdings of all types of securities derivatives. But mutual funds seldom invest in these financial

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[71] COLL 4.5.3R.
[72] Michael Schonten, "The Case for Mandatory Disclosure" (2009) 15 Stanford Journal of Law, Business and Finance 127, 135.
[73] Ibid, 136.
[74] Ibid, 140.
[75] Hu and Black, supra note 50, 876.

products. Given that these economic interests incentivize shareholders to act self-interestedly, they should be disclosed to other shareholders. Emmerich *et al* proposed to narrow the disclosure window under Schedule 13D.[76] They argued that Schedule 13D was formulated in the 1970s, when disclosure could only be made through the post. With electronic reporting, there is no need to allow a 10-day window.[77] Currently hedge funds take advantage of the window by purchasing large quantities of shares in the 10 days, undermining the purpose of Schedule 13D.[78]

Although based on solid grounds, these proposals have considerable negative consequences. Investors only acquire or sell short large positions because they have private information, most of which is produced by them at great costs. Forcing investors to disclose their positions allows others to free-ride on their effort, reducing their incentives to produce such information. More importantly, others' free-riding often increases costs for the investors. Disclosure of large short positions might prompt lenders to raise borrowing fees and to recall shares.[79] For activist shareholders, companies' share price usually rises after the filing of Schedule 13D reports,[80] making it more costly to acquire more shares.

To avoid disclosure, investors might settle with smaller positions. As trading of smaller volume has less significant market effect, too demanding disclosure rules would reduce market efficiency. Jank *et al* studied the effect of short sale disclosure on German investors. They found that investors with 0.4% net short positions were 20-34% less likely to increase their short positions.[81] They also found that because these investors protected their superior private information by avoiding disclosure, they were able to outperform other investors.[82] For activist shareholders, to avoid disclosure by settling with small positions is to forego activism profits, which reduces

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[76] Adam Emmerich, Theodore Mirvis, Eric Robinson and William Savitt, "Fair Markets and Fair Disclosure: Some Thoughts on the Law and Economics of Blockholder Disclosure and the Use and Abuse of Shareholder Power" (2013) 3 Harvard Business Law Review 136, 137.
[77] Ibid, 141.
[78] Ibid, 151.
[79] Stephan Jank, Christoph Roling and Esad Smajlbegovic, Flying under the Radar: The Effects of Short-Salw Disclosure Rules on Investor Behavior and Stock Prices, Accessed on May 27, 2019 at <http://www.fmaconferences.org/Norway/Papers/Transparency_short-sales_FMA_subm.pdf>, 8.
[80] See Chapter 4.
[81] Ibid, 16.
[82] Ibid, 26.

their incentives to engage in activism. Therefore, disclosure rules must balance the need to inform investors against the need to protect investors' incentives to produce private information.

This thesis proposes a two-tier system. First tier disclosure rules should protect investors' private information by allowing them to hide some of their positions and to accumulate more shares in the disclosure window. Hence Schedule 13D in the US should remain. Unlike in the US, boards in the UK cannot frustrate takeovers or disenfranchise shareholders after being notified of their positions. Thus it is justified for the UK to have more stringent disclosure rules.[83] However, instant disclosure of net short positions is likely to reduce short sellers' benefits from identifying undervalued companies and should be relaxed.

Second tier disclosure rules should focus on informing investors. In the UK, authorized funds and fund managers must disclose half-yearly not only their portfolios, including holdings of securities derivatives, but also investment activities occurred in the disclosed period. The Stewardship Code also encourages institutional investors and fund managers to disclose their voting records.[84] Thus to an extent, investors are able to judge from the disclosure whether activism and voting are made out of private interests. In the US, mutual funds and fund managers are required to disclose their portfolios quarterly. But the funds could avoid real disclosure by selling their positions before the end of each quarter and buying them back after disclosure has been made. Fund managers are also not required to disclose short positions or holdings of OTC derivatives.[85] This thesis proposes that all institutional investors should disclose periodically their past investment activities and portfolios, including short positions and holdings in securities derivatives whose value depends on the value of corporate shares.[86] Pension funds and mutual funds should also have a mandatory duty to disclose their votes on shareholder activism.

This would allow investors to review *ex post* whether the activism and the funds'

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[83] Lucian Bebchuk and Robert Jackson, "The Law and Economics of Blockholder Disclosure" (2012) 2 Harvard Business Law Review 39, 53.
[84] See Chapter 7.
[85] Hu and Black, supra note 50, 876.
[86] Ibid, 882.

votes were based on private benefits. Other investors can penalize self-interested shareholders by denying them support in other companies. The problem with this approach is that the disclosure period might be too short to expose ongoing investment strategies. Hence institutional investors should be able to apply to regulators for postponements of disclosure. Suppose a hedge fund is building a position in a company in order to engage in activism. To escape the market's notice, it has been purchasing a small amount of shares each time and keeping its position below the 5% threshold. The proposed rule would require disclosure of investment activities the hedge fund has taken in the quarter and the market would be able to deduce the hedge fund's intention from its incremental accumulation of shares. This would make purchasing more shares expensive for the hedge fund. In that case, the hedge fund could apply to the regulator in charge of disclosure for postponement of disclosure of its purchase of the company's shares. That would be the SEC in the US and the FCA in the UK. For the postponement to be granted, two factors should be satisfied. First, material steps must have already been taken to carry out the investment strategy. In the above example, the hedge fund's investment strategy would not be considered ongoing if it has only purchased a small amount of shares once or twice. Second, disclosure must have considerable detrimental effect on the investment strategy. In the above example, the harm that the shares will be too expensive to acquire after the disclosure would be considerable if the hedge fund does not own enough shares to engage in activism. But if the hedge fund is already one of the company's large shareholders, disclosure would not significantly affect its activism. When both factors are satisfied, disclosure of investment activities relating to the ongoing investment strategy could be postponed until the transactions are concluded.

III. Legal Rules Impeding Shareholder Cooperation

Diversification rules and mandatory ownership disclosure limit institutional shareholdings, forcing activist shareholders to win the support of other shareholders.

As institutional shareholders have divergent private interests, shareholder cooperation can mitigate self-interested activism. This section examines whether there are legal obstacles to shareholder cooperation.

1. US

In the US shareholder cooperation faces two difficulties. First, those who seek to act as shareholders' proxies must file preliminary proxy statements with the SEC. Proxy solicitation can only be commenced after the proxy materials are approved by the SEC.[87] The definition of proxy solicitation used to be vague, leaving shareholders wonder whether discussing how to vote would be considered proxy solicitation. As preparing and filing proxy material is costly, the proxy solicitation rule discouraged shareholder communication and cooperation.[88] The proxy rule was reformed in 1992. The SEC clarified that as long as no proxy is explicitly solicited, shareholder communication would not be construed as proxy solicitation.[89] Making public announcements is also deemed not to be proxy solicitation.[90] In addition, new rules were introduced to facilitate proxy solicitation. Soliciting proxies from ten or fewer shareholders is exempted from the filing requirement.[91] Rule 14a-12 also allows proxies to be solicited before proxy statements are distributed to shareholders as long as the proxy cards are accompanied by proxy statements.[92] Rather than being an obstacle against proxy solicitation, Rule 14a-12 relaxed the proxy rule too far. In proxy fights, corporate management and activist shareholders estimate how many proxies they can secure and decide whether to go ahead with the vote or settle. The outcome of many proxy contests are determined before proxy cards are sent out. Since Rule 14a-12 requires no filing when proxy fights are terminated, it allows proxy

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[87] 17 CFR § 240. 14a-3(a).
[88] Stephen Choi, "Proxy Issue Proposals: Impact of the 1992 Proxy Reforms" (2000) 16 Journal of Law, Economics and Organization 233, 245.
[89] 17 CFR § 240. 14a-2(b).
[90] 17 CFR § 240. 14a-1(2)(iv).
[91] 17 CFR § 240. 14a-2(b)(2).
[92] 17 CFR § 240. 14a-12.

contests to be conducted without any written documentation.[93]

The second obstacle against shareholder cooperation is the group filing requirement under Schedule 13D, which requires shareholders who collectively have beneficial ownership of more than 5% of the company's voting shares to disclose their positions.[94] The scope of Schedule 13D is quite narrow. It only covers shareholders who act in concert to trade shares. Shareholders who coordinate their voting strategies would not be captured by the rule.[95] In *CSX v TCI*, the court ruled that for shareholders to be found to be acting in groups under Schedule 13D, the group leader must have control over other members' shares. As the hedge funds retained discretion over their shares, they were not found to have acted in concert.[96] Nonetheless, the court went on to discuss whether prohibiting the non-reported shares from being voted is an appropriate remedy for Schedule 13D violations. The court reasoned that the primary objective of Schedule 13D is to promptly notify the market of potential acquirers of corporate control. Hence the appropriate remedy for Schedule 13D violations should be corrective disclosure.[97] Such relief was unnecessary in the case in question because most relevant information was disclosed in the hedge funds' anti-trust filings sufficiently in advance.[98] Mild sanctions for violation of Schedule 13D make it an unlikely disincentive against shareholder cooperation.

The loose definition of shareholder groups under Schedule 13D gives rise to wolf pack activism. Activist shareholders might tip other investors in the 10-day window to purchase the company's shares. As the company's share price typically rises after the filing of Schedule 13D, the tippees would make a profit and return the favour by supporting the activist shareholder.[99] In *Sotheby's v Ruprecht*, three hedge funds, Third Point, Trian Partners and Marcato started accumulating shares in Sotheby's in

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[93] Thomas Briggs, "Corporate Governance and the New Hedge Fund Activism" (2007) 32 The Journal of Corporation Law 682, 696.
[94] 17 CFR § 240. 13d-5(b).
[95] CSX v TCI, supra note 53, Judge Winter, at 49.
[96] Ibid, 37.
[97] Ibid, Judge Newman, at 21.
[98] Ibid, 19.
[99] John Coffee and Darius Palia, "The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance" (2016) 41 The Journal of Corporation Law 545, 565.

roughly the same time and eventually reached a collective position of 19%.[100] Third Point launched a proxy fight to replace three directors. In response, the board adopted a two-tier poison pill, which would be triggered if an active shareholder obtained 10% of the company's voting shares or if a passive shareholder obtained 20% of the company's shares.[101] Third Point asked the company to partly redeem the pill to allow it to purchase up to 20% of shares. The company refused.[102] Third Point then sued the board at the Chancery Court of Delaware for breach of duties in the adoption of the pill and in the refusal of its redemption. It also sought a preliminary injunction to postpone the company's general meeting until the conclusion of the trial.[103]

The issue was whether the board's two acts satisfy the *Unocal* tests respectively. With regard to the adoption of the pill, the board argued that the simultaneous accumulation of shares by the hedge funds posed a threat to the company.[104] The argument was strengthened by the fact that the pill was approved by independent directors upon the advice of legal counsels.[105] The court agreed that the probability of the hedge funds' gaining control of the company without paying a control premium, or creeping control, posed a reasonable threat to the company.[106] The court further ruled that the board acted reasonably in relation to the threat because the hedge funds could still win the proxy fight with the pill in place.[107] Hence the board did not breach its duty by adopting the pill.

As to the redemption of the pill, the court ruled that since Third Point did not ask to have the entire pill be removed, creeping control was no longer a threat.[108] But the probability of Third Point having up to 20% of the votes created a threat of negative control, as Third Point could block corporate actions which require supermajority approval.[109] Given the aggressiveness expressed by Third Point during its campaign,

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[100] Sotheby's v William Ruprecht C.A.No 9508-VCP, 27.
[101] Ibid, 21.
[102] Ibid, 49.
[103] Ibid, 2.
[104] Ibid, 40.
[105] Ibid, 42.
[106] Ibid, 41.
[107] Ibid, 45.
[108] Ibid, 50.
[109] Ibid.

the court ruled that the board acted reasonably by refusing to partly redeem the pill.[110] Thus the board did not breach its duty and Third Point's petition was defined.

By recognizing coordinated hedge fund activism as a reasonable threat, *Sotheby's v Ruprecht* opened the door for corporate boards to impede shareholder cooperation. But its application is likely to be limited to shareholders' cooperation to purchase shares. Cooperation in other forms, such as supporting activist shareholders, is unlikely to be affected. Thus there is no significant obstacle against shareholder cooperation in the US.

2. UK

There are two potential obstacles against shareholder cooperation in the UK. First, following the Transparency Directive,[111] the FCA requires shareholders who act in concert to notify the company of their shareholdings when their collective share ownership exceeds 3% of the company's shares.[112] If they fail to do so, the FCA can apply to the court to suspend the shareholders' voting rights.[113] As the sanctions are more severe, the disclosure rule could act as a more serious obstacle against shareholder cooperation in the UK than in the US. But the FCA's definition of acting in concert is quite narrow. Shareholders will only be found to be acting in concert when they have concluded agreements which obligate them to exercise their voting rights to implement policies with a lasting effect on the company.[114] What constitutes lasting policies is unclear. For example, does the appointment of one director have lasting effect on the company? But the FCA's emphasis on the binding nature of the agreement means that shareholders are unlikely to be found to be acting in concert as long as they have discretion over voting their shares. Thus the disclosure rule is not a serious obstacle against shareholder cooperation in the UK.

The second potential obstacle against shareholder cooperation is the mandatory

[110] Ibid, 51.
[111] The Transparency Directive, Article 10(a)
[112] S 178(2), Financial Services and Markets Act 2000
[113] S 4, The Transparency Regulations 2015
[114] DTR 5.2.1

bid rule. Following the Takeover Directive, the Takeover Code requires shareholders who act in concert and collectively hold more than 30% of a listed company's voting shares to make an offer for the remaining shares.[115] Chapter 3 showed that both the agency problem and the collective action problem are exacerbated in the context of takeovers. The UK focuses on the agency problem by prohibiting the frustration of takeovers. The Takeover Directive adopts a similar approach and implements the mandatory bid rule to mitigate the collective action problem. Since shareholders might accept an inadequate offer out of the fear that the share price would be lower after the bidder's acquisition of effective control, the mandatory bid rule assuages this fear by providing shareholders an exit route after changes of corporate control.[116] However, the mandatory bid rule increases costs for bidders as it obligates them to purchase more shares than they need. This is especially the case as the remaining shares must be paid in cash rather than in shares.[117] The fear to be found to be acting in concert and triggering the mandatory bid rule could also be an obstacle against shareholder cooperation.

Different Member States adopt different definitions of acting in concert. In Germany, shareholders are deemed to be acting in concert when they coordinate to bring material and lasting changes to the company. As action in concert is not premised on the existence of shareholder agreements or the seeking of corporate control, the mandatory bid rule becomes a considerable obstacle against shareholder cooperation.[118] Meanwhile in the UK, the Takeover Panel narrowed the scope of action in concert to shareholders' collective action to seek board control.[119] Merely

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[115] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids [2004] OJ L142/12, Article 5.
The Takeover Panel, City Code on Takeovers and Mergers (12 September 2016), Rule 9.1.

[116] Jesper Lau Hansen, The Mandatory Bid Rule: Unnecessary, Unjustifiable and Inefficient, University of Copenhagen Faculty of Law Legal Studies Research Paper No 2018-54, Accessed on May 30, 2019 at < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3112100>, 2.

[117] The Takeover Code, supra note 115, Rule 9.1.

[118] Riccardo Ghetti, "Acting in Concert in EU Company Law: How Safe Harbours can Reduce Interference with the Exercise of Shareholder Rights" (2014) 11 European Company and Fiancial Law Review 594, 614

[119] The Takeover Panel, Practice Statement No 26 Shareholder Activism, Accessed on August 26, 2019 at < http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/ps26.pdf>.

agreeing on how to vote would not be construed as board control seeking.[120] When shareholders nominate directors, whether they are seeking board control depends on their relationships with the directors. If there is no significant relationship, shareholders will not be held as board control-seeking even when they appoint the majority of the board.[121] Significant relationships include directors being former employees of the shareholders, receiving payments from or frequently reporting to the shareholders.[122] Thus the mandatory bid rule is not a significant obstacle against shareholder cooperation in the UK.

IV. Insider Trading

Insider trading rules prohibit those who possess insider information to trade on it. Insider trading regulation could discourage shareholder activism in two ways. First, shareholders fear that in their engagement with the company, insider information might be accidentally disclosed, constraining their liquidity.[123] Second, insider trading regulation would discourage shareholder cooperation if it prohibits activist shareholders from disclosing their activism plans to other shareholders.

1. US

In the US, there is no explicit statutory provision against insider trading. The SEC's Rule 10b-5 prohibits any fraud committed in relation to securities trading.[124] The SEC clarified in *Cady, Roberts&Co* that insider trading is a form of fraud which falls under Rule 10b-5.[125]

Afterwards, insider trading regulation in the US was largely developed in case law. In *Chiarella v United States,* Chiarella was an employee of a printing company

[120] Ibid, [1.4].
[121] Ibid, [3.2].
[122] Ibid, [3.1].
[123] Bernard Black, "Shareholder Passivity Reexamined" (1990) 89 Michigan Law Review 521, 547.
[124] 17 CFR. 240 § 10(b)(5) .
[125] In re Cady, Roberts & Co, 40 S.E.C. 907 (1961), at 907.

which printed takeover announcements. Although the names of the companies were concealed, Chiarella deduced their identities, purchased shares in the targets and sold them after the takeover offers were publicly announced.[126] The court ruled that not every person who knowingly possesses material nonpublic information has a duty to publicly disclose or abstain from trading on the information. This duty arises when the person owes fiduciary duties to the company, such as being its director, officer or controlling shareholder, or when the person is in a relationship of trust and confidence with the company, which is usually the case for professionals such as auditors and lawyers.[127] As neither was the case for Chiarella, he was not liable for insider trading.

In *Dirks v SEC*, Dirks was a broker who was informed by an officer of a company, Equity Funding of America, that the company had committed fraud. Dirks disclosed the information to his clients who sold the company's shares.[128] The court ruled that whether a tippee such as Dirks has a duty to disclose or abstain depends on whether the tipper has such a duty. Thus a tippee's duty is only derivative from the tipper's duty.[129] As Dirks's tipper disclosed the information to Dirks to expose the fraud, not for personal gains, he did not breach his fiduciary duties to the company. Thus Dirks was not liable for insider trading.[130]

Chirarella and *Dirks* established the classic theory of insider trading, which premises liability on whether the traders or their tippers owe duties to the company whose shares they trade. The problem with this theory is that it gives immunity to tippees to trade on insider information as long as the information is disclosed to them properly. In *Dirks v SEC*, the dissenting Justice Blackmun was of the opinion that although Dirks's tipper disclosed the information to him legitimately, Dirks should be liable for insider trading, because instead of disclosing the information publicly as intended by his tipper, Dirks selectively disclosed the information to his clients who were likely to reward Dirks for the information.[131]

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[126] Chiarella v United States 445 U.S.222 (1980) 224.
[127] Ibid, 228.
[128] Dirks v SEC 463 U.S. 646 (1983) 649.
[129] Ibid, 660.
[130] Ibid, 685.
[131] Ibid, 668.

This problem was addressed by the misappropriation theory. In *United States v O'Hagan*, O'Hagan worked at a law firm representing a company which had planned a takeover. He purchased shares in the target and sold the shares after the takeover announcement raised the share price.[132] The court premised insider trading liabilities on whether the trader defrauded the source of information. In the present case, the law firm disclosed the information to O'Hagan with the expectation that it would be kept confidential. O'Hagan misappropriated the information and thus was liable for insider trading.[133]

The SEC requires companies which have selectively disclosed nonpublic material information to publicly disclose the information by filing a Regulation FD, unless the recipient has agreed to keep the information confidential.[134] This does not constrain recipients' liquidity because they are not obligated to keep the information confidential. The burden is on the company to make public filings if they choose not to. Activist shareholders do not owe duties to the company. As information of their activism is produced by themselves, activist shareholders are free to communicate the information to other shareholders. The only exception concerns takeovers. Rule 14e-3 prohibits an offering person from disclosing its takeover plan to others once it has taken substantial steps towards a tender offer.[135]

In *Allegen v Valeant,* Valeant decided to acquire Allegen. Anticipating the takeover to be hostile, Valeant contacted Pershing Square. The two parties signed an agreement according to which Pershing Square purchased 9.7% of Allegen's shares.[136] After Valeant's merger offer was rejected by Allegen's board, Valeant made a tender offer to Allegen's shareholders. In the meantime, Pershing Square launched a proxy fight to replace six of Allegen's directors.[137] Investors who sold their shares before the offer sued Valeant and Pershing Square for Rule 14e-3 violations. They also sued Pershing Square under Rule 14a-9 for not disclosing its agreement with Valeant in its

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[132] United States v O'Hagan 521 U.S.642 (1997) 647.
[133] Ibid, 656.
[134] SEC Regulation FD, codified at 17 CFR Part 243.
17 CFR §243.100(a).
[135] 17 CFR §240. 14e-13.
[136] Allergan v Valeant SACV 14-1214 DOC(ANx) at 5.
[137] Ibid, 24.

proxy statement and sought a preliminary injunction to prohibit Pershing Square from voting its shares.[138]

Valeant and Pershing Square argued that at the time of the disclosure, Valeant had not taken substantial steps towards the takeover. The court rejected this argument. It ruled that Valeant's board meetings, its employment of investment bankers and its negotiation with Pershing Square were all preparations for the takeover.[139] Pershing Square argued that it should be exempted from Rule 14e-3 because it was a co-offering person.[140] The court reasoned that for Pershing Square to be a co-offering person, it must have some control over the offer, such as the ability to determine the bidding price, or control of the merged entity. Instead, its agreement with Valeant showed that Pershing Square was no more than a financer or a strategist.[141] Hence the investors succeeded in showing likelihood of success on the merits of the case. But they were unable to show imminent and irreparable harm. The investors argued that allowing Pershing Square to vote would lead to the election of takeover-supporting directors, which would eventually result in Allegen's acceptance of the value-decreasing offer. The court regarded this harm as speculative and denied the motion.[142] In 2017 the suit was settled for $290 million, with Pershing Square contributing approximately 66% of the settlement.[143]

2. UK

In the UK, section 52 of the Criminal Justice Act 1993 establishes that it is a criminal offence for a person who qualifies as an insider to trade on insider information,[144] encourage others to trade on insider information[145] or disclose insider

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[138] Ibid, 2.
[139] Ibid, 12.
[140] Ibid, 14.
[141] Ibid, 19.
[142] Ibid, 28.
[143] Manas Mishra, Pershing Square, Valeant Arrive at Settlement Split for Allergan Lawsuit, Reuters (December 29, 2017).
[144] Criminal Justice Act 1993, Section 52(1).
[145] Ibid, Section 52(2)(a).

information.[146]

Insider information must be specific, concerning a particular company or event, and price sensitive.[147] The Act recognizes two types of insiders. A primary insider is a person who knows the information to be nonpublic and obtains the information from her position in the company, such as being a director or counterparty in transactions with the company.[148] A secondary insider is a tippee, who knows or reasonably believes that the information comes from an insider and should not be disclosed to her.[149] The difficulty to prove intent and the high criminal burden of proof resulted in limited prosecutions and convictions of insider dealing in the UK.[150] This problem was mitigated by the implementation of the Market Abuse Directive.[151] Section 118 of the Financial Services and Markets Act 2000 prohibits market abuse, including insider dealing.[152] But unlike the criminal offence, civil liability is not premised on whether the trader knew the information to be nonpublic.[153]

The rule on market abuse created a more stringent regime against insider dealing in the UK than in the US. In 2012, a broker of Punch, contacted David Einhorn on behalf of Greenlight, one of Punch's shareholders. The broker asked Einhorn whether he would like to sign a nondisclosure agreement for insider information to be disclosed to him. Einhorn explicitly refused. But the broker proceeded to tell Einhorn that the company planned to issue new shares.[154] After the communication, Einhorn sold his positions in Punch. When the share issuance was publicly disclosed, the company's share price dropped by approximately 30%.[155]

Einhorn argued that as he explicitly refused to sign the nondisclosure agreement, he was entitled to expect that any information disclosed to him was not insider

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[146] Ibid, Section 52(2)(b).
[147] Ibid, Section 56.
[148] Ibid, Section 57(1).
[149] Ibid, Section 57(2).
[150] Paul Barnes, Insider Dealing and Market Abuse: The UK's Record on Enforcement, MPRA Paper No. 25585, Accessed on May 31, 2019 at < https://mpra.ub.uni-muenchen.de/25585/>.
[151] Directive 2014/57/EU of the European Parliament and of the Council of 16 April 2014 on criminal sanctions for market abuse [2014] OJ L173/179.
[152] Financial Service and Markets Act 2000, Section 118(2).
[153] Ibid, Section 118B.
[154] FSA Final Notice to David Einhorn (February 15, 2012) Accessed on February 5, 2018 at <https://www.fca.org.uk/publication/final-notices/david-einhorn.pdf>, para 2.4.
[155] Ibid, para 6.6.

information.[156] According to the FSA (the predecessor of the FCA), this fact did show that Einhorn did not knowingly trade on insider information.[157] But intent is irrelevant under Section 118 of the FSMA 2000. As Einhorn was a shareholder and thus an insider of Punch, the issue was whether the information disclosed to Einhorn was inside information.

Punch's broker disclosed that the company planned a share issuance of £350 million. The capital raised would be used to repay corporate bonds. In an attempt to persuade Einhorn to sign the nondisclosure agreement, the broker also disclosed that the agreement would last for less than a week.[158] The FSA reasoned that viewed alone, none of the information was specific enough. But viewed together, it referred to a particular event whose effect on the share price could be deduced by reasonable investors.[159] Punch's market capitalization was £400 million. Any reasonable investor would expect the fact that it needed to raise £350 million to repay debts to move the share price downwards.[160] Thus the information was insider information. Both Einhorn and the broker were held liable for market abuse.

If the case had occurred in the US, the broker would still be liable for insider trading because he breached his duty to the company. But Einhorn would not have been liable for insider trading as he owed no duty to the company and did not misappropriate the information from the broker. Thus insider trading regulation is more powerful a disincentive against shareholder activism in the UK than in the US.

V. Control Person Liability

If shareholders who have succeeded in activism are considered controlling persons, the associated costs might discourage shareholders from activism.

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[156] Ibid, para 6.2.
[157] Ibid, para 2.10.
[158] Ibid, para 4.41.
[159] Ibid, para 3.31.
[160] Ibid, para 4.12.

1. US

In the US, a 10% share ownership creates a presumption of control. Whether the shareholder is in control is then judged on a case-by-case basis. Facts such as the presence of other large shareholders or no board representation on the part of the shareholder might rebut the presumption of control.[161] A control person would be liable for any securities fraud committed by the company.[162] Regardless of whether they control the company, shareholders holding more than 10% of the company's voting shares are subject to Section 16b of the Securities Exchange Act of 1934. Section 16b also applies to directors and officers. It requires insiders to report to the SEC whenever their positions change. It also prohibits insiders from short selling the company's shares.[163] More importantly, Section 16b requires insiders to disgorge profits made from buying and then selling (or the other way around) the company's securities within six months.[164]

The objective of the rule is to prevent insider trading.[165] Critics argued that the rule failed to achieve this objective by being both too broad and too narrow. The rule is too narrow because it only applies to those who have both purchased and sold the company's shares within the period.[166] The six month bright line makes gaming particularly easy. Financial innovation has also reduced the effectiveness of the rule as it has become more difficult to pinpoint the date of purchase and sale. For example, some commentators argued that converting convertible bonds is a simultaneous sale of the bonds and a purchase of the shares. According to this line of argument, any profits made from the conversion must be disgorged.[167] Others argued that the conversion is only a sale of shares. Section 16b would only be triggered when the

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[161] A Sommer, "Who's in Control-SEC" (1966) 21 Business Lawyer 559, 570.
[162] 15 U.S.C. § 78t-1.
[163] 15 U.S.C. § 78p(b).
[164] Ibid.
[165] Brianna Gates, "The SEC on a Forum Shopping Spree: SEC Enforcement Power and Control Person Liability after Dodd-Frank" (2013) 99 Iowa Law Review 393, 398.
[166] John Munter, "Section 16(b) of the Securities Exchange Act of 1934: An Alternative to Burning Dow the Barn in order to Kill the Rats" (1966) 52 Cornell Law Review 69, 73.
[167] Ibid, 78.

converted shares are sold within six months.[168] The rule is too broad as it allows for no defence. Shareholders who do not have insider information or control over the trading, such as shareholders who hold options which are automatically exercised, are also captured by the rule.[169] The costs imposed by Section 16b are significant. It requires corporate insiders to disgorge the difference between the highest sale price and the lowest purchase price within the period, which usually exceeds their actual trading profits.[170] Thus most hedge funds keep their shareholdings under the 10% threshold.[171]

2. UK

In the UK, company law recognizes three types of directors: de jure directors who are properly appointed, de facto directors who claim to be directors but have not been properly appointed by the company[172] and shadow directors. Shadow directors are those who are not directors, but give instructions which the board is accustomed to follow.[173] Shadow directors owe directors' duties and might have other liabilities, such as liabilities for wrongful trading. Shareholders would be discouraged from activism if successful activist shareholders are considered shadow directors.[174]

In *Re Hydrodan*, the company, Hydrodan, went into liquidation and the liquidator sued its directors for wrongful trading, or for trading while the company was insolvent.[175] The liquidator also sued two directors of Eagle Trust, which wholly owned Hydrodan through its subsidiary, claiming them to be shadow directors of Hydrodan.[176] The court ruled that a person is only a shadow director when the board is accustomed to follow her instructions. In other words, the board is subservient to

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[168] Ibid.
[169] Ibid, 75.
[170] Ibid, 82.
[171] Briggs, supra note 93, 697.
[172] Re Hydrodam (Corby) Ltd [1994] B.C.C 161, 163.
[173] Companies Act 2006, Section 251.
[174] Vivendi Sa v Richards [2013] EWHC 2006, [133].
[175] Insolvency Act 1986, Section 214.
[176] Re Hydrodan, supra note 172, 162.

the shadow director and does not exercise any independent judgement.[177] In this case, the two directors never personally directed the board of Hydrodan. They only participated in Eagle Trust's decision to dispose the assets of its subsidiary, including its shares in Hydrodan. Hence the two directors of Eagle Trust were not shadow directors of Hydrodan. Neither was Eagle Trust, as it only acted as shareholder of the subsidiary.

The test for shadow directors is relaxed in *Secretary of State v Deverell*. The company in this case went into liquidation. The Secretary of State disqualified its directors and two of its consultants, claiming them to be shadow directors.[178] The consultants successfully challenged the disqualification in trial court, whose ruling was overturned in the Court of Appeal. The court ruled that a person can be a shadow director even when she does not control all of the companies' activities. A certain level of influence over some key corporate issues would suffice. Thus it is no longer necessary to show the board's complete surrender of discretion.[179] In this case, one consultant negotiated the sale of the company's assets, recruited managers and had access to the company's bank accounts.[180] Another caused the company to trade while insolvent. Hence both of them were shadow directors.[181]

Deverell raises the probability of activist shareholders being found shadow directors.[182] But it still requires directions of shadow directors to have some patterns and mandatory effect.[183] Activist shareholders who only influence the company on specific matters where the board retains discretion are unlikely to be found as shadow directors.

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[177] Ibid, 163.
[178] Secretary of State for Trade and Industry v Deverell [2001] Ch 340, 344.
[179] Ibid, 354.
[180] Ibid, 359.
[181] Ibid, 362.
[182] Colin Moore, "Obligations in the Shade: The Application of Fiduciary Directors' duties to Shadow Directors" (2016) 36 Legal Studies 326, 329.
[183] Matthew Barber, Boxing Shadows: Secretary of State for Trade and Industry v Deverell and Limits on the Definition of Shadow Directors, Accessed on August 26, 2019 at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1873168>.

VI. Conclusion

This chapter examines potential legal obstacles against institutional shareholder activism. It finds that diversification rules limit the shareholdings of insurance companies, and to a lesser extent, those of mutual funds. But economic disincentives would in any case make mutual funds reluctant to have large shareholdings even if the rules were relaxed. Disclosure rules do not seriously discourage shareholder activism as they allow activist shareholders to hide some of their positions and to accumulate shares within the permitted window. This chapter proposes more extensive disclosure of investment activities for *ex post* review and sanction. There is no significant legal obstacle against shareholder cooperation in the US and the UK. Insider trading regulation is more stringent in the UK, creating disincentives against shareholder engagement with companies. The short-swing rule in the US effectively keeps activist shareholdings below 10%. But given activist shareholders' desire to control risk, it is doubtful whether they would take larger positions even without the rule. The probability of activist shareholders being held as shadow directors is not high in the UK. Therefore, none of the legal rules pose significant legal obstacles to shareholder activism. Given that they are in place to achieve other important objectives, there is no need to reform these rules from the perspective of encouraging efficient shareholder activism, with the exception of some adjustments to disclosure rules.

Chapter 7 Legal Reform to Encourage Efficient Institutional Shareholder Activism

Previous chapters showed that hedge funds have strong incentives to initiate both beneficial and detrimental shareholder activism. As they need the support of other institutional shareholders to succeed, the efficiency of shareholder activism can be increased by encouraging other institutional shareholders to vote on shareholder activism on an informed basis, taking into firm-specific factors. After reviewing existing approaches to encourage efficient shareholder activism, this chapter proposes a regulatory duty of pension funds and mutual funds to vote on shareholder activism to promote long-term corporate value. This duty should include a duty to disclose their voting policies, voting record and explanations for their voting. It should be enforced primarily by market discipline by end investors which is facilitated by public authorities. Public enforcement should function as an enforcement mechanism of the last resort. This enforcement strategy should be implemented using the technique known as the regulatory diamond.

Section I examines whether reflexive regulation could be used to increase institutional shareholders' incentives to vote responsibly and concludes that reflexive regulation alone is not enough. Section II studies rules-based regulation and finds that it is not suitable for institutional shareholder activism. Section III explores principles-based regulation. Section IV introduces the duty of informed voting and its enforcement. Section V concludes.

I. Reflexive Regulation

1. Overview

Broadly regulation can be categorized into three types. When a risk is identified, regulators can design approaches to reduce the risk, command regulatees to follow the

approaches and sanction non-compliance. This is command and control regulation.[1]

Regulators can rely on the market to reduce the risk when two conditions are met. First, there must be markets for the relevant goods. Some goods, such as clean air, are not marketable.[2] Second, the objectives of market participants must be similar to regulatory objectives. For example, the state's goal in corporate governance is mostly to have companies be run fairly and efficiently. This coincides with the objectives of shareholders, justifying market-based systems of corporate governance.[3] Meanwhile, companies' pursuits of profits might conflict with the state's objective in environmental protection, which explains why it is seldom market-based. Market discipline can be affected by market failures. Regulation to mitigate market failures is facilitative or enabling.[4]

Sometimes existing legal framework and the market give regulatees insufficient incentives to pursue regulatory goals. Laws might be introduced in these cases to motivate regulatees to act in ways which are more reflexive of regulatory objectives.[5] The reflexive approach was first proposed by Teubner. Faced with the challenge to promote corporate social responsibility, he proposed that processes could be established to indirectly encourage companies to act in a socially responsible manner. For example, mandating companies to disclose issues which are of interests to various stakeholders would force companies to pay more attention to stakeholder interests.[6]

The market and current legal frameworks in the US and the UK give pension funds and mutual funds insufficient incentives to vote responsibly on shareholder activism.[7] Since corporate governance is traditionally subject to market discipline,

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[1] Darren Sinclair, "Self-Regulation Versus Command and Control? Beyond False Dichotomies" (1997) 19 Law and Policy 529, 534.
[2] Robert Baldwin, Martin Cave and Martin Lodge, *Understanding Regulation* (OUP, 2012), 15.
[3] Ross Grantham, "The Doctrinal Basis of the Rights of Company Shareholders" (1998) 57 The Cambridge Law Journal 554, 584.
[4] See Chapter 3.
[5] Neil Gunningham, "Regulatory Reform and Reflexive Regulation: Beyond Command and Control" in Eric Brousseau, Tom Dedeurwaerdere, and Bernd Siebenhüner (eds) *Reflexive Governance for Global Public Goods* (The MIT Press, 2012), 87.
[6] Gunther Teubner, "Corporate Fiduciary Duties and Their Beneficiaries: A Functional Approach to the Legal Institutionalization of Corporate Responsibility" in Klaus Hopt and Gunther Teubner (eds) *Corporate Governance and Directors' Liability: Legal, Economic and Sociological Analyses of Corporate Social Responsibility* (De Gruyter, 1985), 167.
[7] See Chapter 1.

this chapter first explores whether the reflexive approach could be utilized to increase the funds' incentives. Incentives could be enhanced by increasing the benefits or reducing the costs of informed voting. Relaxing diversification rules would allow pension funds and mutual funds to benefit more from informed voting. But as the previous chapter argued, pension funds and mutual funds are unlikely to have large corporate ownership. The rest of this section examines three approaches to reduce costs of informed voting, namely subsidization of shareholder activism, the use of shareholder collective action vehicles and proxy advisors.

2. Subsidization of Shareholder Activism

Shareholder activism is expensive. Harris found that median spending in shareholder activism was around half a million dollars.[8] He also observed a positive correlation between the amount of spending in shareholder activism and its probability of success. Median spending of successful activist shareholders was found to be $100,000 more than the spending of unsuccessful activist shareholders.[9] Compared to activist shareholders who bear the costs personally, managers fight against shareholder activism using corporate resources.[10] This makes them more willing to spend in campaigning, disadvantaging activist shareholders.

Proposals have been made to redress this imbalance by having companies subsidize shareholder activism. The proxy access rule in the US was in line with this approach, shifting the costs of printing and mailing opposing proxy cards from dissident shareholders to target companies.[11] The problem with this approach is that it encourages inefficient activism, since activist shareholders who do not bear the full costs of failure are less motivated to initiate activism to be approved by a majority of

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[8] Lee Harris, "Shareholder Campaign Funds: A Campaign Subsidy Scheme for Corporate Elections" (2010) 58 UCLA Law Review 167, 176.
[9] Ibid.
[10] Ibid, 168.
[11] Leo Strine, "Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America" (2006) 119 Harvard Law Review 1759, 1776.

shareholders.[12]

Currently activist shareholders who have gained board control can have their expenses reimbursed by the company.[13] But most activism campaigns only seek to pass shareholder proposals or to elect a minority of directors. Considerable costs can be reduced if more activist shareholders, especially unsuccessful ones, are reimbursed by the company. Compared to overall subsidization of shareholder activism, reimbursement would not encourage inefficient activism if it is premised on winning a certain percentage of shareholder support. For example, Bebchuk proposed that dissident shareholders whose director nominees have received more than one-third of votes in proxy fights should have their expenses reimbursed by the company.[14] Similar proposals have already been put in practice. For instance, a bylaw amendment introducing reimbursement of activist shareholders secured 33% of votes in Chevron.[15]

However, reimbursement is not applicable to informed voting. There is no ready measure to judge the quality voting. Even when some measures could be designed, a considerable number of shareholders are likely to meet the criteria. Reimbursing all of them would be burdensome to the company.

3. Shareholder Collective Action Vehicles

Engaging in shareholder activism via collective action vehicles can reduce activism costs. As all members contribute to the group, the free-rider problem is mitigated.[16] Pooled resources allow collective action vehicles to engage in activism the costs of which outweigh individual members' benefits from activism. Duplication of effort, such as on the acquisition of facts, would also be minimized. Over the years, several types of shareholder collective action vehicles have been developed.

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[12] Lucian Bebchuk, "The Myth of the Shareholder Franchise" (2007) 93 Virginia Law Review 675, 698.
[13] Harris, supra note 8, 176.
[14] Ibid, 699.
[15] Joann Lublin, Corporate Funding for Shareholder Activism, The Wall Street Journal (July 3, 2006).
[16] Ronald Gilson and Reinier Kraakman, "Reinventing the Outside Director: An Agenda for Institutional Investors" (1991) 43 Stanford Law Review 863, 887.

In 1992, Robert Monks submitted a shareholder proposal in Exxon to set up a shareholder advisory committee.[17] Members of the committee would be elected by shareholders and should have held shares worth more than $10 million for at least three years. Members would be paid by the company for being on the committee. The company would also pay for the committee's expenses, such as fees of professional advisers. The committee's report would be included in the company's annual reports.[18] Exxon petitioned the SEC to allow it to exclude the proposal from its proxy card.[19] It argued that the deployment of corporate resources was part of the company's ordinary business operations and thus was an improper subject for shareholder proposals.[20] The argument was rejected by the SEC. The SEC stated that the proposal sought to establish a mechanism to evaluate the board's performance, which did not interfere with the company's ordinary business operations.[21] The proposal was voted on but received only 8% of the votes.[22] One year later, CalPERS submitted a shareholder proposal at Pennzoil to set up a shareholder advisory committee which was similar to the one proposed by Monks.[23] But the SEC allowed Pennzoil to exclude the proposal from its proxy card based on the argument that the deployment of corporate assets was part of the company's ordinary business operations and an improper subject for shareholder proposals.[24] As a result of the SEC's drastic change of position, proposals on shareholder advisory committees have since been rare in the US.

The main problem with shareholder advisory committees is that shareholders have weak incentives to participate. Being on the committee requires attendance of committee meetings. It also creates an image of corporate insiders which might restrict members' exit options. Moreover, the decisions of the committees are only

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[17] Charles Richards and Anne Foster, "Exxon Revisited: The SEC Allows Pennziol to Exclude both Mandatory and Precatory Proposals Seeking to Create a Shareholder Advisory Committee" (1992) 48 Business Lawyer 1509, 1510.
[18] Ibid.
[19] Ibid, 1511.
[20] See Chapter 2.
[21] Exxon Corp., SEC No-Action Letter, 1992 SEC No-Act. LEXIS 281 (Feb. 28, 1992).
[22] Richards and Foster, supra note 17, at 1511.
[23] Ibid, 1512.
[24] Ibid, 1515.

advisory. As argued by Rock, members of shareholder advisory committees have the obligations but not the power of directors. Thus shareholders who are willing to engage could simply seek board representation.[25]

Establishing external shareholder collective action vehicles to encourage shareholder activism is not a new theme in academia. For example, Gilson and Kraakman proposed that there should be professional outside directors who work full-time in a number of companies.[26] A clearinghouse should be set up by institutional investors to recruit suitable directors and to evaluate their performance. Its decision to appoint or remove directors would be carried out by member institutions which are shareholders of the companies.[27] Hannes envisioned a similar collective action vehicle with two-tier funding. Fees paid by all members would be used to identify target companies. Activism costs would be shared by members according to their stakes in target companies.[28]

In practice, several external shareholder collective action vehicles have been established. For example, in the US, the Council of Institutional Investors was founded in 1985, which was an organization of private and public pension funds.[29] The Local Authority Pension Fund Forum was formed in 1990 in the UK, representing public pension funds.[30] Empirical studies on external shareholder collective action vehicles generally found positive results. For example, Opler and Sokobin found that activism by the Council of Institutional Investors raised share prices of target companies from below to 9% above the S&P 500.[31] Strickland *et al* studied the returns of members of the United Shareholders Association, an

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[25] Edward Rock, "The Logic and (Uncertain) Significance of Institutional Shareholder Activism" (1991) 79 The Georgetown Law Review 445, 496.
[26] Gilson and Kraakman, supra note 16, 886.
[27] Ibid, 887.
[28] Sharon Hannes, "Brave New World: A Proposal for Institutional Investors" (2015) 16 Theoretical Inquires in Law 245, 254.
[29] Council of Institutional Investors, History, Accessed on June 21, 2019 at <https://www.cii.org/cii_history>.
[30] Local Authority Pension Fund Form, LAPFF History, Accessed on June 21, 2019 at <http://www.lapfforum.org/about-us/history-of-lapff/>.
[31] Tim Opler and Jonathan Sokobin, Does Coordinated Institutional Activism Work? An Analysis of the Activities of the Council of Institutional Investors, Dice Center For Research in Financial Economics, Working Papers Series 95-5, Accessed on June 21, 2019 at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=46880>, at 16.

organization of small investors. They found that in 1993, the USA increased the value of target companies by $1.3 billion. Although it had to be shared with other shareholders, the returns to the members were likely to outweigh the costs, an annual fee of $50.[32] However, most external shareholder collective action vehicles focus on the initiation of shareholder activism, rather than on the evaluation of proposals submitted by activist shareholders.

Industry associations of institutional investors play important roles in the UK where there is a tradition of self-regulation. Various corporate governance guidelines have been issued, such as *The Corporate Governance Policy and Voting Guidelines 2019* of the Pension and Lifetime Savings Association (formerly the National Association of Pension Funds).[33] Most notable is *The Responsibilities of Institutional Shareholders and Agents: Statement of Principles* of the Institutional Shareholder Committee, which is the predecessor of the UK Stewardship Code.[34] Some industry associations provide their members with information on their portfolio companies which reduces voting costs. For example, the Investment Association is an organization of fund managers. It offers its members the Institutional Voting Information Service, but does not make voting recommendations.[35]

Industry associations of institutional investors used to set up case committees to respond to crisis in portfolio companies. Stapledon estimated that in the 1990s, the Association of British Insurers alone operated 200 case committees annually.[36] However, solutions reached by one type of institutional shareholders were not always accepted by institutional investors in other industries.[37] Effort had been made to establish case committees representing all types of institutional investors. But this

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[32] Deon Strickland, Kenneth Wiles and Marc Zenner, "A Requiem for the USA: Is Small Shareholder Monitoring Effective?" (1996) 40 Journal of Financial Economics 319, 336.

[33] Pensions and Lifetime Savings Association, Corporate Governance Policy and Voting Guidelines 2019, Accessed on June 21, 2019 at <https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2019/CG_Voting%20Guidelines%202019%20FINAL.pdf>.

[34] Financial Reporting Council, The UK Stewardship Code (September 2012), 2.

[35] Institutional Voting Information Service, About IVIS, Accessed on June 21, 2019 at <https://www.ivis.co.uk/about-ivis/>.

[36] Geof Stapledon, *Institutional Shareholders and Corporate Governance* (OUP, 1996), 136.

[37] Bernard Black and John Coffee, "Hail Britannia? Institutional Investor Behavior under Limited Regulation" (1994) 92 Michigan Law Review 1994, 2019.

slowed down decision-making and reduced case committees to address non-urgent issues.[38] Eventually case committees lost popularity.[39]

4. Proxy Advisors

Proxy advisors provide shareholders with voting recommendations and have become increasingly influential. For example, Larcker *et al* found that negative voting recommendations from both the Institutional Shareholder Service and Glass Lewis, two of the largest proxy advisors, decreased shareholder support by 34%.[40]

Proxy advisors' growing power raises concerns as to the quality of their voting recommendations. Eckstein noted that 57% of sampled reports issued by proxy advisors had errors. In 44% of cases proxy advisors failed to correct the mistakes after being notified of the errors by the companies.[41] Another concern is whether proxy advisors issue one-size-fits-all recommendations without considering firm-specific factors. Ertimur *et al* examined methodologies used by the ISS and GL to evaluate executive remuneration. They found that neither proxy advisor based their voting recommendations solely on pay-performance sensitivity.[42] Instead, they took into consideration factors such as the quality of the companies' explanations for the payments and the boards' responsiveness to shareholder concerns.[43] In fact, less than half of the companies with low pay-performance sensitivity received negative voting recommendations.[44] This showed that the proxy advisors' methodologies were not generic. Larcker *et al* found that the ISS recommended negative votes on executive

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[38] Ibid, 2021.
[39] Bo Gong, *Understanding Institutional Shareholder Activism: A Comparative Study of the UK and China* (Routledge, 2014), 90.
[40] David Larcker, Allan McCall and Gaizka Ormazabal, Outsourcing Shareholder Voting to Proxy Advisory Firms, Accessed on June 22, 2019 at <http://www.shareholderforum.com/access/Library/20130510_Larcker-McCall-Ormazabal.pdf>, at 29.
[41] Asaf Eckstein, "Great Expectations: The Peril of an Expectations Gap in Proxy Advisory Firm Regulation" (2015 40 Delaware Journal of Corporate Law 77, 115.
[42] Yonca Ertimur, Fabrizio Ferri and David Oesch, "Shareholder Votes and Proxy Advisors: Evidence from Say on Pay" (2013) 51 Journal of Accounting Research 951, 967.
[43] Ibid, 956.
[44] Ibid, 968.

remuneration in 13% of sample companies.[45] GL issued negative voting recommendations in 21% companies. Out of companies which received at least one negative voting recommendation, 79% received negative recommendations from both advisers.[46] If the proxy advisors' voting recommendations were simply based on common best practices, many more of them should have coincided. Thus these studies showed that voting recommendations of proxy advisors were not simply one-size-fits-all opinions.

Proxy advisors' conflicts of interest create another concern. Other than advising shareholders on how to vote, the ISS ranks companies based on their environmental, social and governance practices.[47] It also helps companies to develop policies on these matters.[48] The ISS insists that there are Chinese Walls between its corporate and investor service departments.[49] Chinese Walls are internal procedures to separate departments with conflicting interests.[50] But it is no news that Chinese Walls can be porous. For example, Seyhun studied the effectiveness of Chinese Walls in investment banks between their underwriting and trading departments. He found that when underwriting banks had access to inside information on the issuers, their trading departments transacted in larger volumes and with more profits.[51] Given that Chinese Walls could be ineffective, the possibility that the ISS's rankings and voting recommendations are biased towards its corporate clients creates a serious concern.[52]

The increasing power of proxy advisors has ignited a lively academic debate on whether and how proxy advisors should be regulated. Proxy advisors do not manage assets themselves. In the US, proxy advisors are exempted from the Investment Advisers Act of 1940[53] and its rule to disclose conflicts of interest.[54] The ISS is

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[45] Larcker et al, supra note 40, 20.
[46] Ibid, 21.
[47] ISS, Corporate Solutions, Accessed on June 22, 2019 at < https://www.isscorporatesolutions.com/>.
[48] ISS, ESG Rankings, Accessed on June 22, 2019 at <https://www.issgovernance.com/esg/rankings/>.
[49] Paul Rose, "The Corporate Governance Industry" (2007) The Journal of Corporation Law 102, 134.
[50] H. Nejat Seyhun, "Insider Trading and the Effectiveness of Chinese Walls in Securities Firms" (2008) 4 Journal of Law, Economics and Policy 369, 369.
[51] Ibid, 380.
[52] Ibid, 114.
[53] 15 U.S.C. § 80b-2(a)(11).
[54] 15 U.S.C. § 80b-4.

voluntarily registered under the Act, but its disclosure is far from sufficient.[55] The UK implemented parts of the Shareholder Rights Directive II[56] in the Proxy Advisors (Shareholders' Rights) Regulations 2019. Proxy advisors are required to disclose annually on their websites a code of conduct, a report on their compliance with the code and explanations for non-compliance.[57] Proxy advisors are also required to disclose annually essential features of their methodologies, including how to take market and firm specific factors into consideration, their main sources of information, as well as procedures to manage conflicts of interest and to ensure the quality of voting recommendations.[58]

Opponents of regulation argued that the market can effectively discipline proxy advisors. In 2012, the ISS recommended its clients to vote against Marriot's executive remuneration. Marriot's board argued that the ISS's recommendation was mistaken because it had chosen inappropriate peer companies. Marriot is a hotel management company. But four of the ISS's peer companies were automobile companies. One peer company's market capitalization was 20% of Marriot's.[59] In the end, 87% of votes supported Marriot's executive remuneration. The ISS consequently changed its methodologies in the selection of peer companies.[60] GL also offered a service to distribute companies' responses to its voting recommendations to clients.[61] Li found that after GL entered the market, the ISS's support for shareholder proposals in client companies increased by 11.9 percentage points.[62] This showed that increased competition improved advice quality by mitigating the ISS's bias towards client

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[55] Matthew Fagan, "Third-Party Institutional Proxy Advisors: Conflicts of Interests and Roads to Reform" (2018) 51 University of Michigan Journal of Law Reform 621, 630.
[56] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 Amending Directive 2007/36/EC as regards the Encouragement of Long-Term Shareholder Engagement [2017] OJ L132/1.
[57] Ibid, Article 3j(1).
The Proxy Advisors (Shareholders' Rights) Regulations 2019, Section 3.
[58] Shareholder Rights Directive II, Article 3j(2).
The Proxy Advisers Regulations 2019, S 4.
[59] Marriot International, Inc, Schedule 14a, April 17, 2012 Accessed on July 22, 2019 at <https://marriott.gcs-web.com/static-files/92a46c25-f518-4747-8fd4-eae516ef6747>.
[60] Eckstein, supra note 41, 148.
[61] Owen Walker, Companies Granted Right to Reply on the Glass Lewis Judgments, Financial Times (April 13, 2019).
[62] Tao Li, "Outsourcing Corporate Governance: Conflicts of Interest within the Proxy Advisory Industry" (2018) 64 Management Science 2951, 2959.

companies.[63] Rose observed that due to the ISS's conflicts of interest, many investors had switched to GL, which does not offer corporate and rating services.[64]

However, for market discipline to be effective, institutional investors must genuinely value the quality of proxy advice. Empirical studies were only able to find that a large number of shareholders voted in line with proxy advisors' recommendations.[65] To what extent they followed the proxy advice remains unclear. Institutional shareholders could simply rely on proxy advisors for information on which their voting decisions are based.[66] In the US, the mandatory voting rule and the broker voting rule impose on fund managers a duty to vote on every non-routine issue.[67] In the meantime, they allow the duty to be fulfilled by simply following the recommendations of proxy advisors.[68] Such regulatory endorsement of proxy advice reduces institutional shareholders' incentives to ensure advice quality and the effectiveness of market discipline for proxy advisors.

The effectiveness of market discipline also depends on the competitiveness of the market. The proxy advisory industry is dominated by the ISS and GL, which collectively hold a market share of 97%.[69] This creates positive network externalities.[70] Institutional investors would only deviate from common practice by switching to other proxy advisors when they offer substantially superior advice or lower prices.[71] But as first participants in the market, the ISS and GL have advantages which make new entry difficult.[72] The ISS and GL have reached economies of scale which allow them to cover a wide range of companies at low costs, making it difficult for new entrants to compete on price. Institutional shareholders'

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[63] Ibid, 2964.
[64] Rose, supra note 49, 121.
[65] Larcker el al, supra note 40, 29.
[66] Stephen Choi, Jill Fisch and Marcel Kahan, "The Power of Proxy Advisors: Myth or Reality?" (2010) 59 Emory Law Journal 869, 879.
[67] See Section II.
[68] SEC Administrative Proceeding in the Matter of INTECH Investment Management LLC and David E. Hurley, File No. 3-13463 (May 7, 2009), Accessed on June 23, 2019 at <https://www.sec.gov/litigation/admin/2009/ia-2872.pdf.>.
[69] Eckstein, supra note 41, 232.
[70] See Section II.
[71] Tamara Belinfanti, "The Proxy Advisor and Corporate Governance Industry: The Case for Increased Oversight and Control" (2009) 14 Stanford Journal of Law, Business and Finance 384, 412.
[72] Marvin Lieberman and David Montgomery, "First Mover (Dis)Advantages: Perspective and Link with the Resource-Based View (1998) 19 Strategic Management Journal 111, 112.

insufficient incentives on informed voting also reduce the probabilities of competing on the quality of proxy advice.

Regulation of credit rating agencies sheds light on proxy advisor regulation. Proxy advisors share several features with credit rating agencies. First, both credit rating agencies and proxy advisors are information intermediaries.[73] Credit rating agencies rate companies based on their creditworthieness. Like proxy advisors, they acquire, process information and sell the simplified results, mitigating information asymmetry between companies and investors who are unwilling or incapable to research themselves. Second, credit rating agencies also have conflicts of interest, offering companies whose debt securities are being rated services such as advising on the structuring of bonds. This raises the concern that ratings of their clients might be inflated.[74] Moreover, credit rating agencies operate on an issuer-pays basis.[75] Issuers are willing to pay credit rating agencies to rate their debt securities because certification from the agencies, especially high ratings, reduces their cost of capital.[76] Previously the issuer-pays system did not seriously compromise the integrity of credit rating agencies. This is because credit rating agencies rate debt securities from thousands of companies. Revenue from one company is unlikely to be important enough to make credit rating agencies inflate its rating.[77] The situation changed with the emergence of Collateralized Debt Obligations. Since a few investment banks monopolized the issuance of CDOs, they were able to shop for the highest ratings.[78] This resulted in the inflation of CDO ratings which largely contributed to the subprime mortgage crisis.[79] Third, the credit rating industry is concentrated. S&P, Moody's and Fitch collectively hold a market share of 95%.[80] Positive network externalities and first-mover advantages make competition against them difficult.

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[73] Robert Rhee, "Why Credit Rating Agencies Exist?" (2015) 44 Economic Notes 161, 163.
[74] Paul Justensen, "Ratings Recall: Will New Reform Proposals Make Lasting Impact?" (2009) 35 The Journal of Corporation Law 194, 199.
[75] Lawrence White, "Credit Rating Agencies and the Financial Crisis: Less Regulation of CRAs is a Better Response" (2010) 170 Journal of International Banking Law and Regulation 170, 170.
[76] Ibid, 173.
[77] John Coffee, "Ratings Reform: The Good, the Bad and the Ugly" (2011) 1 Harvard Business Law Review 231, 237.
[78] Ibid.
[79] White, supra note 75, 175.
[80] Eckstein, supra note 41, 228.

Both the US and the EU enhanced regulation of credit rating agencies after the subprime mortgage crisis. Regulators used to allow financial institutions to rely on credit rating agencies for risk assessment. Such regulatory endorsement has been scaled down in both jurisdictions,[81] forcing financial institutions to evaluate the quality of credit ratings.[82] Regulators in both jurisdictions also sought to facilitate market discipline by increasing transparency of credit ratings. Nationally Recognized Statistical Rating Organizations[83] in the US and credit rating agencies in the EU must disclose their main methodologies.[84] They are also required to disclose performance of rated securities until their maturity. Disclosure is mandated annually in the US[85] and half-yearly in the EU.[86] Different approaches were adopted in the US and the EU to encourage competition. In the US, a NRSRO which is hired to rate the issuer's debt securities must share information provided by the issuer with other NRSROs upon request, reducing the costs of competitors.[87] In the EU, structured finance instruments must secure ratings from at least two independent credit rating agencies.[88] It is recommended that one credit rating agency should have a market share of no more than 10%.[89]

Since issuers can switch to other agencies when they find ratings to be unsatisfactory, increased competition might actually reduce the quality of ratings. For example, it was observed that S&P and Moody's inflated their ratings after Finch entered the market.[90] Both the US and the EU tightened regulation on credit rating

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[81] SEC Rule on References to Ratings of Nationally Recognized Statistical Rating Organizations, RIN 3235–AK17.
Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 Amending Regulation (EC) No 1060/2009 on Credit Rating Agencies [2013] OJ L146/1, Article 5a and 5b.
[82] Iris Chiu, "Regulatory Governance of Credit Rating Agencies in the EU: The Perils of Pursuing the Holy Grail of Rating Accuracy" (2013) 4 European Journal of Risk Regulation 209, 211.
[83] Most financial institutions can only invest in debt securities rated by NRSROs, which are registered with the SEC. 15 U.S.Code § 78o-7.
[84] Ibid.
Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies [2009] OJ L302/1, Section D, Annex I.
[85] 17 CFR§ 240.17g-3.
[86] Credit Rating Agency Regulation, supra note 84, Section E, II, Annex I.
[87] 17 CFR§ 240.17g-5(a)(3)(ii) and (iii).
[88] Amendment to the CRA Regulation, supra note 81, Article 8c.
[89] Ibid, Article 8d.
[90] Coffee, supra note 77, 239.

agencies' conflicts of interest to mitigate this problem. In the US, NRSROs must establish procedures to manage conflicts of interest,[91] including fees they charge to rate debt securities.[92] Conflicts of interest must be disclosed.[93] Certain types of conflicts are prohibited. Notably, NRSROs cannot rate debt securities of an issuer which contributed to more than 10% of the organization's net revenue in the previous year.[94] In the EU, credit rating agencies cannot provide ancillary services to rated entities.[95] They must also disclose the identities of entities which contribute more than 5% of their annual revenue.[96]

Regulation of credit rating agencies suggests that for the market to discipline effectively, proxy advisors should be prohibited from issuing proxy advice concerning companies which contribute a substantial portion of their revenue. Regulatory endorsement of proxy advice, such as the mandatory voting rule in the US, discourages investors from evaluating the quality of proxy advice and should be removed. But the problem remains that investors have insufficient incentives to assess the quality of proxy advice. In this case, more transparency on the part of proxy advisors, as required in the EU, is useless. As will be discussed below, this thesis proposes that pension funds and mutual funds should have a duty to vote responsibly on shareholder activism. The duty would require the funds to disclose annually how firm-specific factors were considered in their votes as well as to what extent and why they followed proxy advice. This would force pension funds and mutual funds to evaluate the quality of proxy advice.

The duty's emphasis on firm-specific factors would create opportunities for other proxy advisors to compete against the ISS and GL by specializing in certain types of companies, such as young or high-technology companies. It has become common practice for activist shareholders and corporate boards to make their cases in front of

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[91] 17 CFR§ 240.17g-5(a)(2).
[92] 17 CFR§ 240.17g-5(b)(1).
[93] 17 CFR§ 240.17g-5(a)(1).
[94] 17 CFR§ 240.17g-5(c)(1).
[95] CRA Regulation, supra note 84, Annex I, Section B, Para 4.
[96] Ibid, para 2.

the ISS and GL.[97] Young, small proxy advisors are unlikely to have such access to information. To level the playing field, proxy advisors should be mandated to publicize information provided by activist shareholders or corporate boards. However, it is not appropriate to require pension funds and mutual funds to employ another proxy advisor in addition to the ISS or the GL. On the bright side, doing so gives other proxy advisors opportunities to develop their expertise. Hence although hiring another proxy advisor increases costs for the funds which are likely to be passed on to end investors, the costs might be outweighed by the benefits of enhanced market discipline on proxy advisors. If that is the case, the funds could be required to hire a proxy advisor in addition to the ISS or GL until other proxy advisors have established themselves as serious competitors to the big two. However, even a highly competitive market cannot discipline effectively when consumers of the product cannot assess its quality. Thus the immediate approach should be the implementation of the duty of informed voting. The funds could be required to hire two proxy advisors in the short term if the market remains insufficiently competitive.

To summarize, proxy advisors reduce the costs of voting. But they also create problems which cannot be addressed by market discipline alone. Other approaches to reduce activism costs, namely the subsidization of shareholder activism and shareholder collective action vehicles, are not applicable to informed voting. Thus this section concludes that informed voting cannot be achieved solely via reflexive regulation. The next section explores whether command and control regulation can be used to achieve this goal.

II. Rules-Based Regulation

1. Overview

Legal commands can be roughly categorized into two types, rules and principles.

[97] Owen Walker, *Barbarians in the Boardroom: Activist Investors and the Battle for Control of the World's Most Powerful Companies* (Pearson, 2016), 61.

Rules are relatively detailed while principles are more open-ended. In other words, rules are given content before regulatees act while principles are given content *ex post*.[98] Suppose there is a principle against dangerous driving. The enforcer of the principle is able to decide what constitutes dangerous driving, considering context-specific factors such as the vehicle's speed as well as road and weather conditions. Meanwhile, rulemakers make most decisions *ex ante*. A rule against dangerous driving might prohibit drivers from going beyond a speed limit. Thus rules have higher promulgation costs and lower enforcement costs than principles.[99] This means that when regulated activities and enforcement are likely to occur frequently, it is more efficient to regulate via rules. When the occurrence of regulated activities is likely to be rare, there is no need to incur high promulgation costs. Principles-based regulation is more appropriate in such circumstances.[100]

Since rules are given content *ex ante*, the success of rules-based regulation is dependent on rule-makers' ability to design instruments to efficiently address relevant problems. This is unlikely to be the case when rule-makers are at informational disadvantage *vis-à-vis* regulatees. Moreover, although rules are relatively detailed, they cannot be detailed enough to address all differences among regulatees. This is because beyond a certain point, the costs to optimize the rules would outweigh the benefits.[101] Rule-makers are also keen to avoid discouraging regulatees from learning or complying with the law as a result of lengthy rules.[102] Thus rules would be over-inclusive for some regulatees and under-inclusive for others.[103] This makes rules-based regulation unsuitable for highly heterogeneous regulatees.

Rules are certain, which is both their advantage and disadvantage. Certainty makes circumvention of the rules easy.[104] It also leaves little room for adaptation to

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[98] Louis Kaplow, "Rules versus Standards: An Economic Analysis" (1992) 42 Duke Law Journal 557, 560.
[99] Ibid, 562.
[100] Ibid, 563.
[101] Baldwin et al, supra note 2, 247.
[102] Cristie Ford, "New Governance, Compliance and Principles-Based Securities Regulation" (2008) 45 The American Business Law Journal 1, 29.
[103] Kaplow, supra note 98, 586.
[104] Julia Black, The Rise, Fall and Fate of Principles-Based Regulation, LSE Law, Society and Economy Working Paper 17/2010, Accessed on July 26, 2019 at

changes. Therefore, rules are more appropriate to regulate static matters with little information asymmetry between the regulator and regulatees, where contraventions are frequent and where regulatees are homogenous. Conversely, principles are more appropriate to regulate dynamic matters with severe information asymmetry between the regulator and regulatees, where contraventions are rare and where regulatees are heterogeneous.

Some limitations of rules-based regulation might be mitigated by introducing default rules. Default rules include opt-out rules and opt-in rules. An opt-out default rule applies if regulatees have not contracted on the matter.[105] Model Articles in the UK consist of opt-out default rules.[106] An opt-in default rule only applies when regulatees actively adopt the rule.[107] Staggered boards in Delaware are subject to an opt-in default rule.[108] The ability of regulatees to opt out of rules mitigates concerns on rule-makers' capability to promulgate optimal rules. Default rules also allow for heterogeneity among regulatees.

But the effect of default rules is likely to be limited. First, contracting out of a rule incurs transaction costs. When the costs of suboptimal rules are outweighed by transaction costs, regulatees have incentives to stick with inefficient rules.[109] The problem is exacerbated by status quo bias, that human actors' tendency to maintain the current state of affairs often prevents them from switching to superior alternatives.[110]

Second, rules might give certain parties the power to block changes which are in the collective interests, but against the parties' private interests.[111] For example, charter amendments in Delaware can only be initiated by the board. Suppose shareholders wish to destagger the board. Such a charter amendment is unlikely to be

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<http://eprints.lse.ac.uk/32892/1/WPS2010-17_Black.pdf>, at 7.

[105] Steven Bellman, Eric Johnson and Gerald Lohse, "To Opt-In or Opt-Out? It Depends on the Question" (2009) 44 Communications of the ACM 25, 26.

[106] Companies Act 2006, section 20.

[107] Bellman et al, supra note 105, 26.

[108] Delaware General Corporation Law § 141.

[109] Russell Korobkin, "The Status Quo Bias and Contract Default Rules" (1998) 83 Cornell Law Review 609, 615.

[110] Ibid, 625.

[111] Lucian Bebchuk and Mark Roe, "A Theory of Path Dependence in Corporate Ownership and Governance" (1999) 52 Stanford Law Review 127, 142.

initiated by the board. Shareholders can only submit proposals on the staggering of the board and persuade the board to adopt the proposal if it is passed. Power structures created by the rules impose considerable transaction costs on shareholders, discouraging opting out.[112]

Network externalities also constrain companies' freedom to choose rules. A product's value rests both on its inherent value and network externalities.[113] For example, the inherent value of an online game lies in the attractiveness of its storyline and the quality of images, both of which do not change with the number of players. Positive network externalities are created as more people play the game, such as the establishment of online communities. As the game becomes more popular, its value grows with the increase in positive network externalities while its inherent value remains the same. Network externalities could also be negative. For example, the diamond industry strictly controls the supply because a prevalence of diamonds would weaken their image as luxury goods and reduce their value.[114] Wide adoption of legal rules creates positive rather than negative network externalities. A great number of subjects of the rules is likely to result in more legal disputes, more professional legal services, more court rulings and increased legal certainty.[115] However, when a rule is so widely adopted that it becomes the norm, deviation from the rule requires considerable explanations. The costs to do so might make the parties settle with a suboptimal rule.[116]

Shareholder activism is a highly dynamic matter. New activism strategies and defensive measures are frequently developed, which might make rules obsolete. Compared to first-hand information possessed by activist shareholders and target companies, regulators are outside observers and thus are at an informational disadvantage. Various firm-specific factors affect the efficiency of shareholder

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[112] Lucian Bebchuk and Assaf Hamdani, "Optimal Defaults for Corporate Law Evolution" (2002) 96 Northwestern University Law Review 489, 501.
[113] Michael Klausner, "Corporations, Corporate Law and Network of Contracts" (1995) 81 Virginia Law Review 757, 772.
[114] The Economist, The Future of Forever: A Report from De Beers's New Diamond Mine (February 25, 2017).
[115] Klausner, supra note 113, 777.
[116] Ibid, 790.

activism. Shareholders also differ significantly in their level of diversification and investment horizons. Hence rules are unlikely to effectively regulate shareholder activism. The rest of this section supports this point by examining two possible rules on shareholder activism.

2. Mandatory Voting and Loyalty Shares

In the US, pension funds[117] and fund managers[118] have a duty to vote on every issue. Voting can be delegated to brokers. But the NYSE prohibits brokers from voting on non-routine matters without instructions from shareholders. The scope of non-routine matters has been broadened to include issues such as uncontested director elections.[119] Requiring pension funds and fund managers to vote on every issue in each portfolio company significantly increases their costs. This led to the creation of the ISS, the world's first proxy advisor.[120] Rather than addressing the problem of shareholder passivity, the mandatory voting rule has the unintended consequence of creating powerful proxy advisors.

Loyalty shares have a long history in France. Since 1933, companies could have in their articles of association provisions rewarding shares which have been held for two years with double voting rights. Companies were free to set longer loyalty periods.[121] The rule was amended in 2014. Now listed companies wishing to opt out of the rule must do so by amending their articles of association, which requires approval of two-thirds of shares. The rule remains an opt-in rule for non-listed companies.[122] The response of listed companies to the change showed that they were

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[117] 29 C.F.R. § 2509.2016-01.
[118] SEC Guidance Regarding Proxy Voting: Proxy Voting Responsibilities of Investment Advisers, Release Nos. IA-5325.
[119] NYSE Listed Company Manual, Rule 452.
[120] Fagan, supra note 55, 623.
[121] Jeroen Delvoie and Carl Clottens, "Accountability and Short-Termism: Some Notes on Loyalty Shares" (2015) 9 Law and Financial Markets Review 19, 21.
[122] Macro Becht, Yuliya Kamisarenka and Anete Patjuste, Loyalty Shares with Tenure Voting: A Coasian Bargian? Evidence from the Loi Florange Experience, ECGI Law Working Paper No 398/2018, Accessed on September 16, 2019 at <https://ecgi.global/sites/default/files/working_papers/documents/finalbechtkamisarenkapajuste.pdf>, at 3.

not entirely free to opt out of the rule. It is reasonable to expect that companies which did not have loyalty voting rights before 2014 would prefer to opt out of the rule in 2014. However, Becht *et al* found that 13% of these companies failed to opt out of the rule. As a result, they had the lowest value compared to companies which had loyalty shares both before and after 2014 as well as companies which did not have loyalty shares before 2014 and succeeded in opting out of the rule after 2014.[123]

This approach of granting loyal shareholders more voting rights was also adopted in the US. The repealed proxy access rule allowed shareholders who have held at least 3% of shares for three year to nominate a director on the company's proxy card.[124] The problem with this approach is that holding shares for a certain period of time does not mean that the shareholders would continue to hold the shares. A study conducted by Becht *et al* on 104 French companies found that average holding periods in companies with and without loyalty shares did not differ significantly.[125] There is certainly no guarantee that long holding periods would translate into incentives to promote long-term corporate value.[126] This is especially the case for indexed funds. Giving shareholders more voting rights than economic interests actually encourages them to pursue private benefits. Chapter 2 has argued that multiple classes of shares should be allowed in initial public offerings because investors are free not to invest. Meanwhile, listed companies should not be able to alter their voting structures by reducing shareholders' voting rights because shareholders' collective action problems might prevent them from opposing inefficient changes.[127] But at least in the case of multiple classes of shares, shareholders have a clear idea of the company's voting structure. Since the voting rights of loyalty shares are based on their holding periods, shareholders do not know the number of super-voting shares. This prejudices ordinary shareholders and reduces their incentives to vote.

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[123] Ibid, 14.
[124] See Chapter 2.
[125] Becht et al, supra note, 9.
[126] Hanne Birkmose, "European Challenges for Institutional Investor Engagement: Is Mandatory Disclosure the Way Forward?" (2014) 11 European Company and Financial Law Review 215, 237.
[127] See Chapter 2.

Loyalty shares have gained popularity in the EU. In 2014, the Italian automobile manufacturer Fiat merged with Chrysler, an American car maker. The entity was reincorporated in the Netherlands. One reason behind this decision was that loyalty shares were allowed in the Netherlands, but not in Italy.[128] Italian policymakers quickly responded by permitting loyalty shares.[129] The move was considered by some commentators as a result of a regulatory competition to the bottom.[130] Meanwhile, listing authorities in the US and the UK prohibit loyalty voting rights.[131]

French companies are also allowed to provide in their articles of association financial rewards for shareholders who have held shares for at least two years. The size of the rewards is limited by law. Only 0.5% of a shareholder's shares can participate in the scheme and the rewards are capped at 10% of dividends received by ordinary shareholders.[132] Scholars have proposed more generous financial rewards. For example, Quimby proposed that tax rates on capital gains should be 17.5% for shares which have been held for six months and 15% for shares which have been held for one year. Minimum tax rate would be 5% for shares which have been held for at least three years.[133] Compared to loyalty voting rights, loyalty financial rewards do not create perverse incentives. They also discourage trading based on short-term corporate performance. But they fail to directly motivate shareholders to promote long-term corporate value. Too much emphasis on the length of holding periods might also reduce market liquidity and efficiency, increasing the cost of capital.

Belinfanti rightly argued that financial rewards should not be based on the length of shareholding, but on its quality.[134] She proposed that companies should articulate their long-term objectives and how shareholders can support their pursuits of the

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[128] Marco Ventoruzzo, The Disappearing Taboo of Multiple Voting Rights: Regulatory Responses to the Migration of Chrysler-Fiat, ECGI Law Working Paper No 288/2015, Accessed on August 9, 2019 at < https://ecgi.global/sites/default/files/working_papers/documents/SSRN-id2574236.pdf>, 3.
[129] Ibid, 1.
[130] Ibid, 2.
[131] NYSE Listed Company Manual, § 313.00(A).
FCA Handbook, Listing Rules 7.2.1A.
[132] Delvoie and Clottens, supra note 121, 20.
[133] P Quimby, "Addressing Corporate Short-Termism Through Loyalty Shares" (2013) 40 Florida State University Law Review 389, 411.
[134] Tamara Belinfanti, "Shareholder Cultivation and New Governance" (2014) 38 Delaware Journal of Corporate Law 789, 852.

objectives. Shareholders who meet the company's mission-sustaining criteria would receive financial rewards.[135] The problem with this approach is that leaving it to the company, shareholders' support for the company's long-term objectives is likely to be equated to supporting the management. Corporate schemes which reward shareholders who have held their shares or voted for management proposals would reduce shareholders' incentives in corporate governance.

III. Principles-Based Regulation

1. Overview

Principles are relatively open-ended, leaving it to regulatees to decide how to comply. Hence principles-based regulation enrolls regulatees in the regulatory landscape, utilizes their expertise and could be particularly beneficial when information asymmetry between the regulator and regulatees is severe.[136] Heterogeneous regulatees are allowed to comply with the principles taking their idiosyncrasies into consideration. By observing the functioning of different compliance strategies and by interacting with regulatees, regulators learn more about the regulated activities and the regulated persons. That knowledge can be used to better assess the quality of compliance and to guide regulatees.[137] The open-ended nature of principles also allows the regulator and regulatees to respond to changes by adopting different compliance and enforcement strategies. Since principles-based regulation enrolls regulatees, it is also described as management-based regulation, enforced self-regulation or meta-regulation, which generally refers to the regulation of self-regulation.[138]

Principles-based regulation poses certain challenges. First, regulators must be

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[135] Ibid, 853.
[136] Julia Black, "Enrolling Actors in Regulatory Systems: Examples from UK Financial Services Regulation" (2003) Public Law 64, 69.
[137] Ford, supra note 102, 30.
[138] Sharon Gilad, "It Runs in the Family: Meta-Regulation and Its Siblings" (2010) 4 Regulation and Governance 485, 486.

able to assess the quality of compliance. Principles-based regulation can be categorized into two types, process-based and outcome-based regulation.[139] Process-based regulation sets procedural standards. Requiring companies to have independent committees is one example of process-based regulation. Outcome-based regulation sets goals, such as for industrial companies to control the emission of greenhouse gas under a certain amount. For principles-based regulation to function properly, regulators must be able to assess the effectiveness of the processes or to measure the output, which can be difficult.[140]

Second, regulators must be able to impose sanctions proportionate to the level of non-compliance. By enrolling regulatees, the relationship between the regulator and regulatees is transformed from one of command and control to one of cooperation and trust.[141] Too harsh a sanction would erode this relationship, make regulatees too risk-averse to devise their own compliance strategies and reduce principles-based regulation to box-ticking practices.[142] But if non-compliance is not sufficiently sanctioned, regulatees would lose incentives to comply. Thus regulators must have a broad range of enforcement tools to match different levels of non-compliance.

Third, public enforcement is sensitive to the political environment.[143] For example, a financial crisis often results in more resources being allocated to financial regulators, more enforcement actions and more severe sanctions, while enforcement intensity might be relatively low in other times. Given the *ex post* nature of principles, legal consistency is more of a concern for principles than for rules.

As argued before, shareholder activism is a dynamic matter, with severe information asymmetry between the regulator and regulatees and high heterogeneity among regulatees. Hence if the challenges can be overcome, principles-based regulation would be appropriate for shareholder activism. The rest of this section examines two of such attempts, the proposed duty of loyalty for activist shareholders

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[139] Julia Black, Martyn Hoper and Christa Band, "Making a Success of Principles-Based Regulation" (2007) 1 Law and Financial Markets Review 191, 192.
[140] Gilad, supra note 138, 488.
[141] Black, supra note 104, 12.
[142] Ibid, 6-7.
[143] Peter Mascini, "Why Was the Enforcement Pyramid So Influential? And What Price Was Paid?" (2013) 7 Regulation and Governance 48, 52.

and the UK Stewardship Code.

2. The Duty of Loyalty for Activist Shareholders

Currently in both the US and the UK, ordinary shareholders do not owe any company law duty to the company. This is because shares and the attached voting rights are shareholders' property. Property-owners are *prima facie* entitled to use their property in whatever way they like.[144] Only majority shareholders or other shareholders who have systematic control of the company owe a duty of loyalty to the company.[145] But these shareholders can be considered directors and their duties directors' duties.[146]

Anabtawi and Stout argued that this approach on shareholders' duties was formulated when the ownership of public companies was dominated by passive retail investors.[147] Now institutional shareholders have positions which allow them to exercise control in some, but not all circumstances. This makes self-interested activism a serious concern. Hence Anabtawi and Stout proposed that a duty of loyalty should be imposed on shareholders who have exercised control on specific matters.[148] When shareholders exercise control on a corporate action and receive private benefits, the duty would require the action to be approved by a majority of independent directors or shareholders.[149]

Anabtawi and Stout prescribed a "but for" test to judge whether shareholders have exercised control, asking whether corporate actions would have taken place without the shareholders' actions.[150] Obviously initiators of shareholder activism would satisfy this test. The problem is with other shareholders. Suppose a merger

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[144] Zipora Cohen, "Fiduciary Duties of Controlling Shareholders: A Comparative Review" (1991) 12 University of Pennsylvania Journal of International Business Law 379, 381.
[145] See Chapter 2.
[146] Hanne Birkmose, "Duties Imposed on Specific Shareholders Only and Enforcement Implications" in Hanne Birkmose and Konstantinos Sergakis (eds) *Enforcing Shareholders' Duties* (Edward Elgar, 2019), 48.
[147] Iman Anabtawi and Lynn Stout, "Fiduciary Duties for Activist Shareholders" (2008) 60 Stanford Law Review 1255, 1268.
[148] Ibid, 1275.
[149] Ibid, 1295.
[150] Ibid, 1297.

proposal could have been passed by securing one more vote. Does this mean that every shareholder who did not vote or who voted against the merger has exercised control on the matter? Anabtawi and Stout also defined shareholders' private benefits broadly. A shareholder who holds shares in the company's competitor would be captured by their definition.[151] Using this approach, determining which shareholders are independent would be complicated. The duty is likely to apply to a number of shareholders. Subjecting their transactions to the approval process would be costly and slow down decision-making.

Company law is of a private nature.[152] Assigning activist shareholders a company law duty can only be based on control, which is not practical. But shareholders do have duties in securities law, notably the duty to disclose large shareholdings.[153] Securities law is of a more public nature. Shareholders' duties are rooted in the public interest in market efficiency.[154] This raises the question whether a duty to the public can be imposed on institutional shareholders, which will be explored in the next section.

3. The Stewardship Code

As a response to the subprime mortgage crisis, the UK government commissioned Sir David Walker in 2009 to review corporate governance in banks and other financial institutions.[155] One of the review's recommendations was to assign a duty of stewardship to institutional investors.[156] The recommendation was adopted by the Financial Reporting Council, which introduced the Stewardship Code in 2010. The Code was revised in 2012 and 2019.[157] It only applies to voluntary signatories.

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[151] Ibid, 1287.
[152] See Chapter 3.
[153] See Chapter 6.
[154] Iris Chiu, "Private vs Public Enforcement of Shareholder Duties" in Hanne Birkmose and Konstantinos Sergakis (eds) *Enforcing Shareholders' Duties* (Edward Elgar, 2019), 115.
[155] Sir David Walker, A Review of Corporate Governance in UK Banks and other Financial Industry Entities: Final Recommendations (26 November 2009).
[156] Ibid, para 5.7.
[157] Financial Reporting Council, Update on Proposed Revision to the UK Stewardship Code, Accessed on August 9, 2019 at < https://www.frc.org.uk/investors/uk-stewardship-code>.

The FRC maintains a list of signatories on its website.[158] The FCA requires authorized fund managers to disclose whether they have adopted the Code or provide explanations for not adopting the Code.[159] Wong estimated that about 100 institutional investors and 200 fund managers have adopted the Code.[160]

The 2012 Code requires signatories to promote long-term corporate value in a way that their end investors and society will benefit.[161] More specifically, it requires institutional investors to monitor their investee companies[162] and when necessary, to engage with the companies in an escalating order, from meeting with management to removing directors.[163] The Code requires signatories to disclose their policies on monitoring[164] and engagement with investee companies,[165] including how they manage conflicts of interest[166] and how they cooperate with other shareholders.[167] Signatories are required to disclose annually how they have discharged their stewardship responsibilities and voting records, including to what extent the recommendations of proxy advisors have been followed.[168] The Code operates on a comply-or-explain basis. Explanations should be provided for deviation from the Code's principles.[169] The EU introduced the Second Shareholder Rights Directive[170] in 2017. Article 3g of the Directive requires institutional investors and asset managers to disclose their policies on shareholder engagement to promote long-term corporate value, including how to monitor the company's social and environmental impact and how to cooperate with other stakeholders, especially employees. It also requires institutional investors and fund managers to disclose annually how the polices have been implemented. Article 3g operates on a comply-or-explain basis but disclosure is

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[158] Financial Reporting Council, The UK Stewardship Code (September 2012), 3.
[159] FCA Handbook, Conduct of Business Sourcebook (COBS) 2.2.3R.
[160] Simon Wong, "Is Institutional Investor Stewardship Still Elusive?" (2015) Butterworths Journal of International Banking and Financial Law 508, 508.
[161] The Stewardship Code (2012), supra note 158, 1.
[162] Ibid, Principle 3.
[163] Ibid, Principle 4.
[164] Ibid, Principle 3.
[165] Ibid, Principle 4.
[166] Ibid, Principle 2.
[167] Ibid, Principle 5.
[168] Ibid, Principle 6 and 7.
[169] Ibid, 4.
[170] Supra note 56

mandatory. Compared to the Stewardship Code, Article 3g asks institutional investors to play a more important role in the public interest with more transparency. The UK revised the Stewardship Code in 2019 partly to implement the Directive. The new Code still only applies to voluntary signatories. Adding to the 2012 Code, the new Code requires signatories to disclose their organizations' purposes and how they fit with signatories' policies on shareholder engagement.[171] Signatories are also required to engage with investee companies on social and environmental issues[172] and to go beyond the performance of their portfolios to respond to market-wide risks.[173] The outcomes of signatories' stewardship responsibilities should be disclosed as well.[174]

The Stewardship Code encourages institutional investors and fund managers to monitor their investee companies and to engage in activism when necessary. The benefits of large shareholder monitoring alone cannot explain why the Code only applies to the funds and their managers, not other large shareholders.[175] The most likely reason is that the funds' social impact gives them a duty to the public. The fact that the Directive and the revised Code expanded the scope of stewardship to engagement on environmental, social and market-wide issues support this point. However, the Code is too path dependent to acknowledge its public nature or to deviate from voluntary adoption by being mandatory as the Directive prescribes.[176] This thesis proposes that the Stewardship Code should be amended to clarify its public nature and be mandatory to pension funds, mutual funds and their fund managers.

The main problem with the Stewardship Code is enforcement. The comply-or-explain approach relies on end investors to evaluate the funds' explanations for non-compliance, to either make the funds comply with the Code or to switch to more compliant funds. The hope is that the fear of losing clients would motivate the funds to be more responsible shareholders. The Corporate Governance

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[171] Financial Reporting Council, The UK Stewardship Code (September 2020), Principle 1.
[172] Ibid, Principle 7.
[173] Ibid, Principle 4.
[174] Ibid, Principle 6.
[175] Birkmose, supra note 146, 50.
[176] Arad Reisberg, "The UK Stewardship Code: On the Road to Nowhere?" (2015) 15 Journal of Corporate Law Studies 217, 230.

Code also operates on a comply-or-explain basis. Observers have long noticed that shareholders' enforcement of the Corporate Governance Code is not fully effective. For example, Moore noted that most shareholders do not care whether the company complies with the Code as long as the company is performing well.[177] When the company underperforms, shareholders tend to blindly oppose any non-compliance with the Code even when it could be beneficial to the company.[178] As explanations for non-compliance are ignored in both cases, most companies do not give informative explanations for their non-compliance.[179] Arcot and Bruno studied how comply-or explain works for the Combined Code, the predecessor of the Corporate Governance Code. They found that noncompliance was not explained in 17% of cases. Of the explanations that were provided, most of them simply stated that non-compliance was in the best interests of the company or repeated the wording of the Code. The same explanations were often given for several years.[180]

End investors' enforcement of the Stewardship Code is likely to be even less effective. Several rounds of corporate governance movements have made shareholders realize the importance of corporate governance to corporate success. The link between engagement with certain portfolio companies and the funds' financial returns is more tenuous.[181] Like shareholders, end investors are dispersed and have collective action problems. But unlike shareholders who can directly influence corporate governance, end investors are only part of the investment chain. They can request the funds to be more engaged shareholders. The funds need to communicate this request to fund managers who might further delegate corporate governance. Each part of the chain must monitor whether the delegatees duly carry out the request. The

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[177] Marc Moore, "Whispering Sweet Nothings: The Limitations of Informal Conformance in UK Corporate Governance" (2009) 9 Journal of Corporate Law Studies 95, 119.
[178] Ibid, 112.
[179] Ibid, 126.
[180] Sridhar Arcot and Valentina Bruno, In Letter but not in Spirit: An Analysis of Corporate Governance in the UK, Accessed on December 16, 2019 at <https://pdfs.semanticscholar.org/1fc6/3b7cfb29833229cce4006e5154de093cbb8f.pdf?_ga=2.198304943.1467694730.1577887584-71213585.1574511929>
[181] Iris Chiu, "Institutional Shareholders as Stewards: Toward a New Conception of Corporate Governance" (2012) 6 Brooklyn Journal of Corporate, Financial and Commercial Law Review" 387, 406.

complexity of the process is likely to discourage end investors from making the request in the first place.[182] Shortening the investment chain is not desirable because the chain has been partly developed to protect end investors. For example, without independent depositaries, fund managers of multiple funds could transfer assets from underperforming funds to outperforming funds to improve their overall performance.[183] Moreover, compared to shareholders, end investors have fewer alternatives to switch to, reducing the effectiveness of market discipline.

Recognizing the weakness of comply-or-explain, proposals have been made for regulators to sanction the most insufficient explanations for non-compliance with the Corporate Governance Code.[184] This approach was rejected by the FRC.[185] Soft law, like the Corporate Governance Code, nudges regulatees to act or not act in certain ways,[186] while allowing regulatees to decide whether to comply based on their specific circumstances. Compared to traditional soft law approach, the comply-or-explain approach maintains regulatees' flexibility. But by requiring companies to explain for non-compliance, it invites investors to evaluate the companies' choices.[187] The FRC decided against public enforcement of the Corporate Governance Code because investors are better placed than regulators to make these firm-specific evaluations.

The Stewardship Code is different from the Corporate Governance Code in this aspect. The Corporate Governance Code prescribes corporate governance practices whose effect is firm-specific. The Stewardship Code focuses mostly on the disclosure of institutional investors' and fund managers' policies and records on the discharging of stewardship responsibilities. The costs of policymaking and disclosure might be

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[182] Iris Chiu and Dionysia Katelouzou, "Making a Case for Regulating Institutional Shareholders' Corporate Governance Roles" (2018) Journal of Business Law 67.

[183] Roger Barker and Iris Chiu, *Corporate Governance and Investment Management: The Promises and Limitations of the New Financial Economy* (Edward Elgar, 2017), 76.

[184] Andrew Keay, "Comply or Explain in Corporate Governance Codes: In Need of Greater Regulator Oversight" (2014) 34 Legal Studies 279, 296.

[185] FRC Response to the European Commission Green Paper on the EU Corporate Governance Framework, Accessed on Jun2 29, 2019 at <https://www.frc.org.uk/getattachment/19dd5d2f-8570-4994-b889-2cee7152e8dc/FRC-response-to-the-Green-Paper-on-the-EU-corporate-governance-framework-July-2011.pdf>, 5.

[186] Chiu, supra note 154, 117.

[187] Konstantinos Sergakis, "Deconstruction and Reconstruction of the Comply or Explain Principle in EU Capital Markets" (2015) 3 Accounting, Economics and Law: A Convivium 233, 239.

burdensome to small institutions while insignificant to large institutions.[188] But overall, the effect of the Stewardship Code is not highly firm-specific. Thus there is no compelling reason to rely exclusively on the comply-or-explain approach. This thesis proposes that public authorities should strengthen the enforcement of the Code. This proposal will be discussed in the next section.

IV. Duty of Informed Voting

1. Overview

This thesis proposes that pension funds and mutual funds should have a duty to vote on shareholder activism with the aim to promote long-term corporate value. The previous section has showed that assigning shareholders such duty in company law is not entirely practical. But the duty can be based on public policy.[189] In the US and the UK, citizens are encouraged to provide for retirement income in private means, by investing in pension funds, life insurers and mutual funds. These institutional investors invest a large portion of their assets in corporate shares, making many end investors who would not have invested in stocks themselves dependent on the success of the corporate sector. The funds have commoditized share ownership, transforming it from a privilege enjoyed by the wealthy to a household item.[190] This is why the current system is also characterized as one of forced capitalism.[191] Since pension funds, insurance companies and mutual funds make the public dependent on the well-being of the corporate sector in the long term, they should have a duty to the public to promote the long-term value of their portfolio companies. Insurance companies have been regulated differently. Hence for the time being the duty of

[188] Sajiv Edelman, "Proxy Advisory Firms: A Guide for Regulatory Reform" (2013) 62 Emory Law Journal 1369, 1405.
[189] Iris Chiu, "From Shareholder Stewardship to Shareholder Duties: Is the Time Ripe?" Nordic&European Company Law No 18-10, Accessed on June 27, 2019 at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2731241>, at 145.
[190] Barker and Chiu, supra note 181, 24.
[191] Jennifer Hill, Images of the Shareholders: Shareholder Power and Shareholder Powerlessness, New York University Law and Economics Research Paper No. 15-23, Accessed on July 19, 2019 at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2664430>, at 7.

informed voting should only be assigned to pension funds and mutual funds. It is also more pragmatic to narrow the duty to one of informed voting on shareholder activism. The duty would require the funds to ensure informed voting of their fund managers. But to facilitate enforcement, the duty of informed voting should also be assigned to fund managers of pension funds and mutual funds.

Institutional investors already owe private duties to end investors to manage their assets prudently and in their best interests. The best interest of end investors is mostly interpreted as maximizing financial returns of the funds. Informed voting does not necessarily translate into financial returns. Informed voting has costs. There is also no guarantee of the voting outcomes, the effect of shareholder activism on the company or that the funds' benefits would outweigh the costs of informed voting. But the current interpretation of the funds' duty is too limited. It has long been argued that the best interests of end investors should include governance, environmental and social concerns.[192] Given that end investors rely on the well-being of the corporate sector in the long term, it is in their best interests to have all retail investment funds vote responsibly on shareholder activism. Hence the funds' duties to the public to vote responsibility do not severely interfere with their private duties to end investors. The duty of informed voting also does not prevent the funds' from exiting when the company faces detrimental shareholder activism. This seems to limit the effect of the duty. But restraining the funds' exit options would distort fund managers' decision-making. The funds might exit or not invest in companies which are likely to become activism targets to preserve liquidity. This would increase market volatility and deprive certain companies of capital. Meanwhile, the effect of the duty is unlikely to be materially limited even with unrestricted exit. Knowing that remaining institutional shareholders are obligated to vote responsibly facilitates shareholder cooperation. It in turn encourages the funds to consider seriously the value of their shares on sale both at the present time and if the activism is not successful. Funds in companies with better prospects are more likely to stay on and to reach to other funds

[192] Anna Tilba and Arad Reisberg, "Fiduciary Duty under the Microscope: Stewardship and the Sepctrum of Pension Fund Engagement" (2019) Modern Law Review 1, 27.

to vote against detrimental shareholder activism. Those who would be most affected by the duty are indexed and quasi-indexed funds with restricted exit options. This result is desirable given the growing trend in indexation.

The duty of informed voting should be accompanied by disclosure. Given that disclosure can be costly, the duty of disclosure should be assigned using a size-based approach, which is similar to risk-based regulation. In risk-based regulation, the regulator assesses the risk a regulatee can impose on the regulatory goal and focuses resources on regulatees who pose the highest level of risk.[193] In size-based regulation, regulatory intensity varies according to regulatees' impact, which is usually dependent on their size. This approach is used in the US to regulate hedge funds.[194] This thesis proposes that the funds and their fund managers should be categorized into three types. The largest funds and their fund managers should disclose their voting policies, voting records and explanations for their votes on shareholder activism. The disclosure of voting policies would allow the identification of shareholders with similar preference and facilitates shareholder cooperation.[195] But voting policies are only likely to be effective to a certain extent because the impact of shareholder activism is highly firm-specific. As designing and updating voting policies could be expensive, medium-sized funds and their managers should only disclose their voting records and explanations for their votes on shareholder activism. Since the duty of informed voting is based on the funds' social impact, small funds could be exempted from the duty and only have to disclose their voting records.

Voting records of funds and fund managers should not be aggregated. Suppose a mutual fund has both internal and external fund managers. Internal managers delegate voting to the fund's corporate governance department. Different external managers rely on different proxy advisors. Several fund managers invest in the same company. Some fund managers vote for while others vote against a proposal. Current regimes in the US and the UK allows the mutual fund to disclose its aggregated voting record on

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[193] Julia Black and Robert Baldwin, "Really Responsive Risk-Based Regulation" (2010) 32 Law and Policy 181, 184.
[194] See Chapter 6.
[195] Konstantinos Sergakis, "The UK Stewardship Code: Bridging the Gap between Companies and Institutional Investors" (2013) 47 Revue Juridique Themis 109, 130.

the proposal, where the for and against votes are cancelled out. This makes evaluation of voting quality difficult. This thesis proposes that voting records of funds in the same fund family or of fund managers employed by the same fund should not be aggregated.

Funds and their fund managers should also explain their votes on shareholder activism, referring to firm-specific factors. If proxy advisors are used, they should explain to what extent and why their recommendations have been followed. This requires them to review proxy advisors' methodologies and conflicts of interest. Pension funds and mutual funds should also disclose their own conflicts of interest, including relationships with the company and initiators of activism as well as interests in companies whose value might be affected by the activism.

In the UK, the duty of informed voting can be implemented by amending the Stewardship Code. The current Code requires signatories to monitor their investee companies. But pension funds and mutual funds have insufficient incentives to initiate shareholder activism. Enforcement of the Code is also too weak to motivate the funds to do so. Meanwhile, hedge funds have strong incentives to initiate both beneficial and detrimental shareholder activism. Therefore, regulatory priority should be ensuring the efficiency of the existing level of activism, not encouraging more activism. Thus the scope of stewardship responsibilities should be narrowed to a duty to vote responsibly on shareholder activism. Since most pension funds, mutual funds and their managers are already signatories to the Code and have been required to disclose their voting policies and records, making the Code mandatory and the additional requirement to explain their votes are unlikely to be overly disruptive.

In the US, the Investor Stewardship Group, an organization of institutional investors and fund managers, introduced the Framework for US Stewardship and Governance in 2018. It encourages signatories to disclose their policies on shareholder engagement to promote long-term corporate value and to periodically disclose their engagement activities.[196] It was estimated that signatories to the

[196] Investor Stewardship Code, Stewardship Principles, Accessed on January 1, 2020, at <https://isgframework.org/stewardship-principles/>

Framework had more than $31 trillion invested in the US equity market,[197] but to what extent the Framework is followed remains to be seen. Implementing the duty of informed voting in the US would require the introduction of mandatory disclosure of the funds' voting policies, records and explanations for voting. Although the changes would be more drastic in the US than in the UK, given the aforementioned developments in the market, they are in line with market needs and are unlikely to encounter significant obstacles in implementation.

This thesis proposes the same overall approach for the US and the UK. The two countries differ mainly in the level of shareholder power, which results in different scales of shareholder activism. As argued before, the efficiency of the existing level of shareholder activism should be ensured before encouraging more activism and the difference between the US and the UK is irrelevant to this end.

2. Enforcement

This thesis proposes that the duty of informed voting should be enforced primarily by end investors with the facilitation of public authorities. Public enforcement should function as an enforcement mechanism of the last resort. A regulatory diamond should be used to enforce the duty of informed voting.

Both market discipline by end investors and public enforcement have shortfalls. The previous section showed that end investors have weak incentives to enforce the funds' stewardship responsibilities which are based on the funds' private duties to end investors because corporate engagement might not increase the funds' financial returns. The duty of informed voting is based on the public interest. Informed voting ensures the long-term well-being of the corporate sector on which end investors are dependent. Educating citizens on this point could enhance the enforcement of the duty by end investors.

In addition to protecting consumers, financial regulators in both the US and the UK also seek to educate consumers to make them more responsible buyers and to

[197] Ibid.

increase market discipline.[198] For example, the SEC's Office of Investor Education and Advocacy answers investors' questions in investing.[199] The FCA runs investor education projects in primary and secondary schools, higher education institutions and in the workplace.[200] Empirical studies on the effect of investor education mostly reached unsatisfactory results.[201] However, most investor education programs aim to increase investors' financial literacy, which involves actual imparting and receiving of knowledge. Investor education on informed voting only needs to make investors accept the notion that the funds' informed voting is beneficial to them in the long-term. It is much simpler and more likely to succeed than other investor education programs. Hence the thesis proposes that the SEC and the FCA should educate the workforce on the importance of informed voting to increase their incentives to enforce the duty.

Nevertheless, the ability of end investors to enforce the duty is limited. First, effective enforcement requires end investors to tell to what extent the funds have complied with the duty, which is unlikely given end investors' limited expertise. Second, end investors can enforce the duty by exiting noncompliant funds or demanding higher quality of voting. But as argued before, end investors' voice and exit options are limited. Thus public enforcement must facilitate and complement market discipline. In the US, pension funds are governed by the Department of Labor. Mutual funds and fund managers are regulated by the SEC. In the UK, pension funds are regulated by the Pension Regulator. Mutual funds and fund managers are regulated by the FCA. This thesis proposes that to unify enforcement, the duty of informed voting should be enforced by the SEC in the US and the FCA in the UK.

Regulators can facilitate end investors' enforcement by assessing the level of the funds' compliance with the duty. Whether the funds' explanations for voting are informative can be judged at the outset. In the UK, the FRC has already been categorizing signatories into tiers based on the informativeness of their disclosure

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[198] Toni Williams, "Empowerment of Whom and for What? Financial Literacy Education and the New Regulation of Consumer Financial Services' (2007) 29 Law and Policy 227, 231.
[199] The SEC'S Office of Investor Education and Advocacy, Investor Publications, Accessed on July 29, 2019 at < https://www.sec.gov/reportspubs/investor-publications/investor-pubs-aboutoieahtm.html>.
[200] Williams, supra note 198, 237.
[201] Daniel Fernandes, John Lynch and Richard Netemeyer, "Financial Literacy, Financial Education and Downstream Financial Behaviors" (2014) 60 Management Science 1861, 1861.

following the Stewardship Code.[202] The SEC and FCA should follow this approach by pointing out funds that provide insufficient explanations. This would facilitate the discipline of end investors. But whether voting is really informed and beneficial to the company in the long term is hard to be judged. Suppose a hedge fund engages in activism to have the company sell its control over a subsidiary. The subsidiary has been generating losses for years. It is kept by the company because the company wishes to expand into its market in the future. If, knowing this reason, the institutional shareholder still supports the sale to reap quick returns, regulators would not be able to tell from the disclosure that the voting is myopic. However, the effect of the activism can be deduced from the company's performance eventually. Thus, this thesis proposes that regulators should assess the quality of voting by examining the company's performance in the relatively long term, say within a two-year period. Regulators should compare the performance of target companies before and two years after shareholder activism. Pension funds and mutual funds should be ranked based on changes in corporate value. If more than one of the fund's portfolio companies experienced shareholder activism, their changes of value should be aggregated. A certain percentage of funds, say ten percent, whose investee companies experience the largest decline or increase in value should be punished or rewarded using a regulatory diamond, which will be explained below. This approach would encourage the funds to vote more responsibly and facilitate end investors' enforcement by pointing out funds with the best and worst compliance. One problem with this approach is that there are not always causal links between corporate performance and shareholder activism, especially taken into consideration external factors. But this concern is mitigated as changes in corporate value are aggregated and actions are only taken against a certain percentage of funds. Another associated problem is that in some cases it might appear that there is no need to wait for two years to see the efficiency of the activism campaign. For example, a company may have been selling assets to maintain its profitability. But the idea of assessing the performance of target companies after two

[202] Financial Reporting Council, Tiering of Signatories to the Stewardship Code, Accessed on January 1, 2020, at <https://www.frc.org.uk/news/november-2016/tiering-of-signatories-to-the-stewardship-code>

years is to focus on the relative long term. Hence other than the company's insolvency, regulators should not pay much attention to the company's current performance.

Nevertheless, market discipline by end investors whose exit and voice options are limited is unlikely to be fully effective, even with the help of public authorities. Thus it should be complemented by public enforcement. Public enforcement has its limitations as well. Regulators are at an informational disadvantage vis-à-vis the funds. They also have insufficient funding and staff to evaluate the efficiency of all activism campaigns and the funds' votes. Assessing the quality of the funds' voting on the basis of changes in value of target companies mitigates this problem to some extent. But public enforcement would also create an impression that the duty is being effectively enforced. This would reduce end investors' incentives to enforce and have a signaling effect on funds against whom regulators fail to act. In other words, there would be a gap between what regulators are capable of and what the market expects.[203] Hence it is important to keep public enforcement as an enforcement mechanism of the last resort.

This thesis proposes that when a fund has been the bottom or top ten percent three times its fund manager should be fined or financially rewarded, the amount of which could be the fund's pro rata share of the companies' changes in value. It would not be appropriate to impose fines on the funds because such fines are likely to be passed on to end investors. Fund managers who has been fined three times should be disqualified from engaging in the asset management business. These harsh sanctions are likely to be employed rarely to avoid the expectation gap. But their availability would further encourage voluntary informed voting.

The proposed enforcement of the duty of informed voting can be implemented using the technique known as the regulatory diamond. Research on principles-based regulation has recognized that sanctions must be proportionate to the level of non-compliance. Ayres and Braithwaite built on this and argued that enforcement should also be responsive to the attitude of regulatees. In other words, regulators should be able not only to measure the level of non-compliance, but also to tell

[203] Eckstein, supra note 41.

whether non-compliance is a result of unwillingness or incompetence.[204] At the core of this responsive regulation is the regulatory pyramid.[205] At the outset regulatees are assumed to be willing and competent. When non-compliance occurs, enforcers would start enforcement from the bottom of the pyramid with persuasive measures, helping regulatees to better comply with the standards. As non-compliance reoccurs, regulatees would be assumed to be less willing or competent to comply. Enforcers would move up the pyramid to more punitive measures.[206]

One criticism against the regulatory pyramid is that it only aims to achieve compliance, which should be the minimum. For example, Kolieb argued that regulation should be aspirational, encouraging regulatees to go beyond the standard.[207] This argument is especially pertinent to institutional shareholders. Although for the sake of practicality this thesis focuses on informed voting on shareholder activism, it would be beneficial if institutional investors could be aspired to be more engaged shareholders. To achieve aspirational regulation, Kolieb transformed the regulatory pyramid into a regulatory diamond, where regulatees are rewarded for good compliance.[208] This thesis adopts this technique to enforce the duty of informed voting. (See Figure 1)

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[204] Mascini, supra note 143, 51.
[205] Neil Gunningham, "Enforcement and Compliance Strategies" in Robert Baldwin, Martin Lodge and Martin Cave (eds) *The Oxford Handbook of Regulation* (OUP, 2012), 125.
[206] Ibid.
[207] Jonathan Kolieb, "When to Punish, When to Persuade and When to Reward: Strengthening Responsive Regulation with the Regulatory Diamond" (2015) 41 Monash University Law Review 136, 146.
[208] Ibid, 150.

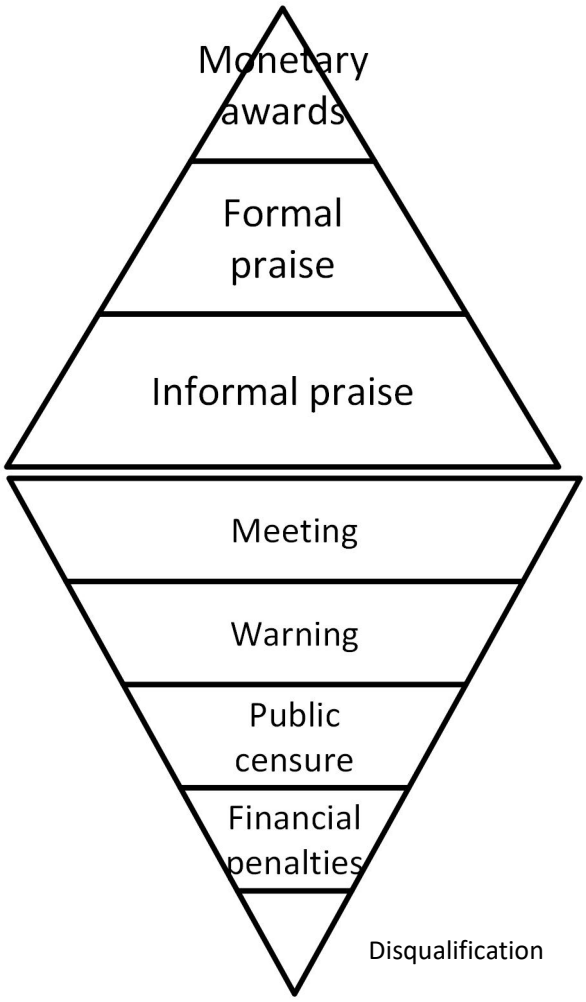

Figure 1

The SEC and the FCA should assess the informativeness of the funds' explanations for voting, especially how they have taken firm-specific factors into consideration, and point out funds with the poorest disclosure as a warning. Funds which produce the most insufficient disclosure for the second time should be publicly censured. For the third time, fund managers should be fined. Suppose 5% of the fund's assets are invested in the company in question, the fund manager's fine should be 5% of her remuneration. Fund managers should be disqualified if unmeaningful explanations are given for the fourth time. The sanctions escalate quickly because disclosure is not a demanding duty and the level of its compliance can be judged straight away.

Regulators should assess the performance of target companies two years after shareholder activism. Funds should be ranked based on changes in corporate value. Funds which make the bottom 10% for the first time should meet with the regulators

to explain how they plan to improve voting in the future. Regulators should issue formal warnings to funds who are at the bottom 10% for the second time and publicly censure those who make the bottom for the third time. Fund managers whose funds have received public censures twice should be fined if they are to be sanctioned again. They should be disqualified if they have been fined twice and their funds are at the bottom again. Funds which make the top 10% would move up the regulatory diamond. Suppose a fund receives a warning in the previous year. It will move up the diamond if it is at the top 10% this year. This means that it will have a warning again if it makes to the bottom 10% in the next year.

There are two problems with the regulatory diamond. First, catastrophe might happen before regulators moving down the diamond, leaving regulators with sanctions which are disproportionate to the harm. But this problem is mostly relevant to those who directly cause the catastrophe, not the funds. Second, the imposition of severe sanctions might destroy relationships between regulators and regulatees, which renders moving up the diamond later impossible. This problem is also not relevant to the current case because the quality of informed voting is evaluated objectively.

V. Conclusion

The social impact of pension funds and mutual funds mean that they should have a regulatory duty to vote on shareholder activism to promote long-term corporate value. This duty should be transferred to their fund managers. The funds and their managers should disclose annually their voting policies, voting records and explanations for their votes on shareholder activism. The duty should be enforced primarily by market discipline by end investors. The SEC in the US and the FCA in the UK should facilitate market discipline by assessing the performance of target companies in a certain period. Investor education on the importance of informed voting should follow to enhance market enforcement of the duty. Public enforcement, namely the imposition of fines and the disqualification of fund managers, should complement market enforcement as an enforcement mechanism of the last resort. This

enforcement strategy should be implemented using the technique known as the regulatory diamond.

Chapter 8 Conclusion

This thesis examined the economic effect of shareholder activism and designed legal reform to increase its efficiency.

It argued that shareholders and other stakeholders participate in the company to mitigate opportunism by other parties. Hence the company's objective should be the maximization of the aggregated utility of all corporate constituencies and the efficiency of shareholder activism should be assessed by comparing its benefits to its costs to the company in the long term. To make this assessment, firm-specific factors, including the competitiveness of the product market, the innovativeness of its business, corporate life stage and organizational structures, must be taken into consideration. This thesis found that mainstream institutional shareholders have weak economic incentives to initiate such activism or to vote on shareholder activism based on firm-specific factors. Rather than being discouraged by legal rules, their passivity is caused by economic disincentives, namely liquidity concerns, externalities of activism, conflicts of interest and fund managers' agency problems. Most of these economic disincentives do not exist for hedge funds. Hence hedge funds have incentives to initiate shareholder activism, but they also have incentives to engage in self-interested activism, myopic activism or activism with negative externalities.

Most hedge fund activism cannot succeed without the support of other shareholders. Given the significant social impact of pension funds and mutual funds, this thesis proposed that they should have a regulatory duty to vote responsibly on shareholder activism to promote long-term corporate value. This duty should be accompanied by a duty to publicly explain the way they use their voting power. The duty should be enforced primarily by end investors with the facilitation of regulators. Given that market enforcement is not strongly effective, public enforcement should complement is as an enforcement mechanism of the last resort. This enforcement strategy can be implemented using a regulatory diamond.

This thesis makes an original contribution to research on the subject in two aspects. First, existing research has not explored the issue of how the same type of

shareholder activism campaign can have different effects on companies with different characteristics. This thesis fills the gap by conducting case studies to identify possible factors and to tentatively test their effect on the economic outcome of shareholder activism. The hypotheses formed in this thesis can guide future empirical studies. Second, the significant social impact of mainstream institutional investors has long been recognized, but little acted upon. This thesis is one of the first comprehensive attempts to design detailed and pragmatic approaches on enhancing the corporate governance roles of pension funds and mutual funds in tandem with the magnitude of their social impact.

The main limitation of this thesis is that the public duty it proposes is only practically enforceable as far as domestic institutional shareholders are concerned. But institutional investors are increasingly investing overseas. In the UK, share ownership by overseas institutional investors has dwarfed share ownership by domestic institutional investors. The continuation of the trend, which is highly likely, might limit the practical significance of the proposed public duty on domestic pension funds and mutual funds from a UK perspective. Nevertheless, institutional investors are still likely to hold certain amounts of domestically quoted shares. Informed voting on their parts can encourage overseas investors to vote more responsibly. Cooperation between national regulators could also mitigate this problem, although it is an issue which lies beyond the scope of this thesis.

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