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A THEORY OF SHAREHOLDER ACTIVISM AND ITS PLACE IN CORPORATE LAW

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A THEORY OF SHAREHOLDER ACTIVISM AND ITS PLACE IN CORPORATE LAW

BERNARD S. SHARFMAN*

Offensive shareholder activism (more commonly known as hedge fund activism) can be understood as a corrective mechanism in the governance of a public company. The legitimacy of offensive shareholder activism as a corrective mechanism is based on numerous empirical studies that have found this type of activism to be both wealth enhancing for shareholders and performance enhancing for the target companies. A non-empirical argument can also be made in support of offensive shareholder activism that focuses on the ability of the board of directors to act as an impartial arbitrator deciding between the advices provided by executive management and the activist hedge fund.

Recognizing the value of offensive shareholder activism in the decision making of a public company allows for the following theory of shareholder activism: Shareholder activism is a valuable asset in and of itself if the purpose of such activism is to correct managerial inefficiencies. This new theory is built on the foundation of Henry Manne's market for corporate control.

The implications for corporate law are significant. If corporate law does not recognize offensive shareholder activism as a corrective mechanism, then the benefits of such activism in terms of enhancing the managerial efficiency of public companies and increasing shareholder wealth may become significantly reduced. To facilitate this recognition, this Article provides new thinking on how Delaware's Unocal *test and* Blasius *standard of review should be applied by the courts when the Board takes action to minimize the influence of activist hedge funds. Under both standards of review it is argued that corporate law should always take a skeptical view of any Board action taken to directly or indirectly mitigate the influence of this type of activism. This approach is not about shifting decision-making authority from the Board to activist hedge funds, but simply putting limits on the Board's ability to use the legal system to thwart the influence of hedge fund activism in a public company's decision-making process.*

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INTRODUCTION

In "Shareholder Activism as a Corrective Mechanism in Corporate Governance,"[1] Paul Rose and Bernard Sharfman identified offensive shareholder activism (more commonly known as hedge fund activism) as a *corrective mechanism* in the governance of a public company.[2] A corrective mechanism is defined as a part of a public company,[3] other than the board of directors ("Board") or

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1. Paul Rose & Bernard S. Sharfman, *Shareholder Activism as a Corrective Mechanism in Corporate Governance*, 2014 BYU L. REV. 1014 (2014).

2. *Id.*

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

executive management, which may have, from time to time, superior decision-making skills in the making of major corporate decisions.[4] The legitimacy of offensive shareholder activism as a corrective mechanism is based on numerous empirical studies that have found this type of activism to be both wealth enhancing for shareholders and performance enhancing for public companies.[5] A non-empirical

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2016) [hereinafter Sharfman, *Activist Hedge Funds*], *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2576408.

4. Unlike the definition used by Rose and Sharfman, *see* Rose & Sharfman, *supra* note 1, this definition recognizes executive management as a locus of authority that is separate and distinct from the Board. However, the definition used here is consistent with the one used by Sharfman in a subsequent article: "In the context of the public company, the activist hedge fund may [be] a competing locus of authority [with executive management and have the role of] corrective mechanism in the decision making of a large organization." *See* Sharfman, *Activist Hedge Funds, supra* note 3, at 126 (citations omitted).

5. *See* Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1731 (2008) [hereinafter Brav, et al. *Hedge Fund Activism, Corporate Governance*]; *see also* Nicole M. Boyson & Robert M. Mooradian, *Corporate Governance and Hedge Fund Activism*, 14 REV. DERIVATIVES RES. 169, 175–78, 201 (2011) (examining data from 1994–2005 and finding that hedge fund activism improved by short and long-term performance of companies); Christopher P. Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists*, 14 J. CORP. FIN. 323, 324 (2008) (finding that in a control group containing hedge funds that filed Schedule 13Gs, "firms targeted by hedge funds for active purposes earn larger, positive [returns] than firms targeted by hedge funds for passive purposes"); Robin M. Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON. 362, 374 (2009) (finding that "activists are most successful at creating value when they are able to [force] a change in control"); Dionysia Katelouzou, *Myths and Realities of Hedge Fund Activism: Some Empirical Evidence*, 7 VA. L. & BUS. REV. 459, 479 (2013) (examining empirical results consistent with these studies but focusing on hedge fund activity outside the United States); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187, 213, 217–18 (2009) (focusing on activist campaigns by both hedge funds and other types of entrepreneurial activists, the study found that both types of campaigns produced average abnormal returns for target shareholders); Alon Brav et al., *Shareholder Power and Corporate Innovation: Evidence from Hedge Fund Activism* (Ind. Univ., Kelly Sch. of Bus., Working Paper No. 2014-05, 2014) (finding a link between improvements in innovation efficiency and hedge fund activism at firms with a diverse set of patents as a result of the activism leading to a more targeted approach to innovation); C.N.V. Krishnan et al., *Top Hedge Funds: The Importance of Reputation in Shareholder Activism* (Vand. L. Sch., Law & Economics Working Paper No. 15-9, 2015) (discussing that hedge fund activism continues to generate positive announcement–period abnormal stock returns using a dataset collected from 2008 through mid-2014); Shane Goodwin, *Myopic Investor Myth Debunked: The Long-Term Efficacy of Shareholder Advocacy in the Boardroom* 10–13 (June 13, 2014) (unpublished manuscript), *available at*

argument has also been made in support of hedge fund activism that focuses on the defining attribute of today's public company, Board independence.[6] This argument can be summarized as follows: "An activist hedge fund can create long-term value at a public company if the Board has enough independence to act as an impartial arbitrator deciding between the advices provided by executive management and the activist hedge fund."[7]

Recognizing the value of offensive shareholder activism in the decision making of a public company allows for the development of a theory of shareholder activism that can be understood as an extension of Henry Manne's theory on the market for corporate control.[8] Manne argued that control of a public company was a valuable asset in and of itself if used to correct managerial inefficiencies.[9] Shareholder activism can be thought of in the same manner: a valuable asset in and of itself if the purpose of such activism is to correct managerial inefficiencies.

The implications for corporate law are significant. If corporate law does not recognize offensive shareholder activism as a corrective mechanism, then the benefits of such activism in terms of enhancing the managerial efficiency of public companies and increasing shareholder wealth may become significantly reduced. To facilitate this recognition, this Article provides new thinking on how Delaware's *Unocal* test and *Blasius* standard of review should be applied by the courts when the Board takes action to minimize the influence of activist hedge funds. Under both standards of review, it is argued that corporate law should always take a skeptical view of any Board action taken to directly or indirectly mitigate the influence of this type of activism.[10] This approach is not about shifting decision-making authority from the Board to activist hedge funds, but simply putting limits on the Board's ability to use the

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http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2450214 (reporting excess returns for activist hedge funds who gain board representation).

6. *See generally* Sharfman, *Activist Hedge Funds*, *supra* note 3.

7. *Id.*

8. Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965) [hereinafter Manne, *Mergers & the Market*]. The influence of this article in corporate law scholarship cannot be understated. *See* William J. Carney, *The Legacy of "The Market for Corporate Control" and the Origins of the Theory of the Firm*, 50 CASE W. RES. L. REV. 215 (1999). Manne's article has been ranked as the 29th most cited law review article of all time. *See also* Fred R. Shapiro & Michelle Pearse, *The Most-Cited Law Review Articles of All Time*, 110 MICH. L. REV. 1483, 1490 (2012).

9. Manne, *Mergers & the Market*, *supra* note 8, at 112.

10. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1946); Blasius Indus. Co. v. Atlantic Corp., 564 A.2d 651 (Del. Ch. 1988).

legal system to thwart the influence of hedge fund activism in a public company's decision-making process.

The discussion that follows, when it references state corporate law, has been pragmatically framed in the context of Delaware corporate law. Delaware is the state where the majority of the largest United States companies are incorporated,[11] and its corporate law often serves as the authority that other states look to when developing their own statutory and case law.[12] Therefore, the primary examples are from Delaware, but the thinking is meant to be global in nature.

This Article proceeds as follows: Part I discusses the market for corporate control. Part II explains how corporate law supports the market for corporate control. Part III presents a theory of shareholder activism. Part IV discusses the presumption that the board of directors is the locus of authority that is in the best position to make the most important corporate decisions. Part V discusses the interaction between corporate law and offensive shareholder activism and presents an approach that corporate law can take to recognize and incorporate offensive shareholder activism so that its benefits are maintained. Part VI concludes by summarizing this Article's findings and recommendations.

I. THE MARKET FOR CORPORATE CONTROL

In this Article, a theory of shareholder activism is built on the foundation of Henry Manne's market for corporate control. Manne's theory begins with the premise that there is "a high positive correlation between corporate managerial efficiency and the market price of shares of that company."[13] Such a premise means that the price of a public company's stock will in part reflect managerial performance. Manne used this premise to argue that "the control of corporations may constitute a valuable asset" in and of itself, an asset that "exists independent of any interest in either economics of scale or monopoly profits," if the acquirer takes control with the

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

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

13. Manne, *Mergers & the Market*, *supra* note 8, at 112.

expectation of correcting managerial inefficiencies.[14] At the time this was considered a novel argument, as the prevailing worldview believed that the only reason for acquisitions, especially in the context of horizontal mergers, was a pernicious one: the desire to reduce competition, acquire economies of scale without internal growth, and earn the maximum amount of monopoly rents possible from the transaction.[15]

Critical to this theory is the existence of a liquid stock market where potential acquirers could assess the price of the stock versus what the price could be with better management.[16] According to Manne: "Apart from the stock market, we have no objective standard of managerial efficiency."[17] Manne provides the following description of how the market for corporate control operates:

> Briefly, the market for corporate control in our system operates in the following manner: if an existing corporation with publicly traded shares is poorly managed, holders of those shares will respond by selling. This will drive the price down to the point indicated by the quality of management which the corporation is receiving. As the price of securities of any corporation is thought to be low relative to the price that would be generated by more efficient managers, the stage is set for the critical functioning of the market for corporate control. Outsiders, whether we call them "raiders" or more polite names, will respond to the opportunity to make substantial capital gains (not necessarily in the tax sense) by buying control, managing the company efficiently, and then perhaps disposing of the shares. It is not necessary that they remain permanently to manage the business.[18]

Manne used the term "raiders" to describe acquirers in the market for corporate control.[19] The use of this term connotes a surprise attack, or at the very least an unfriendly takeover bid where the Board of the target is against the idea of being acquired, such as when Mesa Petroleum Company engaged in a hostile, two-tier, front-loaded tender offer to take over Unocal Corporation, a

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14. Sharfman, *Activist Hedge Funds*, *supra* note 3, at 114 (citing Manne, *Mergers & the Market*, *supra* note 8, at 112).

15. Manne, *Mergers & the Market*, *supra* note 8, at 110–11.

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

17. *Id.*

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

19. *Id.*

fact pattern that led to the famous Delaware Supreme Court opinion in *Unocal Corp. v. Mesa Petroleum Co.*[20]

Historically speaking, Manne's choice of words should not be surprising. During the 1960s, when Manne wrote his article and prior to the heavy regulation of tender offers, there was a much higher level of hostile takeover activity than today.[21] His use of the term raider also helps to highlight the point he was making: that the acquirer could profit handsomely from correcting managerial inefficiencies exclusive of economies of scale or monopoly rents.[22] However, Manne did not limit the definition of an acquirer to a corporate raider or hostile bidder.[23] The friendly acquisition is a perfectly acceptable way of gaining control for purposes of implementing efficiencies, even though Manne suggested that some sort of side payment to the target's management was usually involved in order to get their sign-off.[24]

Moreover, the desire to profit from managerial inefficiencies can apply to a wide range of acquirers who may be in a position to evaluate valuable information about a company's managerial strengths and weaknesses, including competitors, customers, and suppliers, among others.[25] These are the kind of companies that constantly interact with the target and may have unique insights into the managerial inefficiencies that need correcting based on their own understanding of how their companies operate and what they observe at the target company.[26]

Acquirers who participate in the market for corporate control, i.e., those who are motivated at least in part by the profits that can be earned by correcting managerial inefficiencies, can be categorized as a very special subset of what Zohar Goshen and Gideon

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20. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 946–59 (Del. 1946) (creating a two-pronged test, commonly referred to as the *Unocal* test, to review defensive measures taken by a board of directors to repel attempts by an outside investor or group of investors to gain control of the corporation).

21. According to professors Cain, McKeon, and Solomon, "The 1960s [was a decade] characterized by high rates of hostile takeover activity." Matthew D. Cain et al., *Do Takeover Laws Matter? Evidence from Five Decades of Hostile Takeovers* 10 (AFA Boston Meeting Paper July 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2517513. In 1967, 40% of takeovers were hostile. *Id.* In the 1970s "hostile activity peaked at 28.9% and then again fell." *Id.* In the 1980s, hostile activity peaked at between 10 to 15%. *Id.* Since that time, hostile activity has averaged below 10%. *Id.*

22. Manne, *Mergers & the Market*, *supra* note 8.

23. *Id.* at 117–18.

24. *Id.* at 118.

25. *Id.*

26. *Id.* at 118–19.

Parchomovsky call "information traders."[27] These traders trade in the financial markets based on non-public research and analysis and "are willing and able to devote resources to gathering and analyzing information as a basis for their investment decisions."[28] Besides acquirers, information traders include activist hedge fund managers, money managers, and even market professionals who specialize in providing recommendations to investors based on non-public research and analysis in exchange for compensation.[29] "[I]nformation traders [look for differences] between value and price based on the information they possess . . . [t]hen trade to capture the value of their informational advantage."[30] Information traders move security prices toward their fundamental values and are in essence "the agents who render markets efficient."[31]

Paradoxically, information traders who have the necessary information, but do not participate in the market for corporate control, create the foundation for the market's success. A critical assumption surrounding the market for corporate control is that the vast majority, or at least a significant number, of information traders would rather sell their shares than attempt to acquire control. Information traders prefer to "vote with their feet,"[32] rather than becoming proactive in the corporate governance of any particular firm.[33] Unsurprising, since participating in the market for

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

28. *Id.*

29. *See id.*

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

31. *Id.* at 719.

32. According to Professors Armen Alchian and Harold Demsetz in their seminal article *Production, Information Costs, and Economic Organization*

> Any shareholder can remove his wealth from control by those with whom he has differences of opinion. Rather than try to control the decisions of the management, which is harder to do with many stockholders than with only a few, unrestricted salability provides a more acceptable escape to each stockholder from continued policies with which he disagrees.

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

33. Rose & Sharfman, *supra* note 1, at 1030–33.

corporate control means "raising large amounts of capital necessary to acquire" a firm, as well as possessing the managerial expertise required to correct the inefficiencies at the target firm.[34] "Moreover, becoming an acquirer may mean giving up the benefits of portfolio diversification as the acquisition becomes an overweighed investment in the information trader's portfolio and therefore exposes the trader to non-systematic risk."[35] As a result, it should be expected that a significant number of information traders are "value investors,"[36] investors who devote "[w]hatever limited time, resources, and skill they have to" valuation, not to the process of gaining control and correcting managerial inefficiencies.[37]

However, a low share price[38] resulting from a significant number of information traders voting with their feet does provide an opportunity for an information trader who is willing and able to make the investment necessary in acquiring control and has the required expertise to correct the managerial inefficiencies that exists.[39] Once these inefficiencies have been corrected, the information trader can then sell its investment for a large profit if it so desires.[40]

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34. Sharfman, *Activist Hedge Funds*, *supra* note 3, at 113.

35. *Id.*

36. As discussed previously, Gilson and Gordon refer to institutional investors who are value investors, earning returns based on fundamental analysis and diversification, and liquidity traders, earning returns through low cost diversification as "rationally reticent." Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 867 (2013). They vote, but they do not propose or get involved in trying to influence the management of the corporation. *Id.* According to Gilson and Gordon: "Institutional owners who are not seeking private benefits of control are rationally reticent; they also will assign a low value to governance rights since their proactive exercise will not improve the relative performance on which the institutional investor's profitability and ability to attract assets depends." *Id.* at 895 (footnote omitted).

37. Rose & Sharfman, *supra* note 1, at 1033.

38. According to Manne:

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

Manne, *Mergers & the Market*, *supra* note 8, at 113.

39. *Id.*

40. *Id.*

Finally, it is important to note that if an active market for corporate control exists, then the stock market can provide an effective means to limit managerial divergence from shareholder wealth maximization,[41] the presumed default objective of corporate governance. Moreover, the minimizing of this opportunistic behavior will be of great benefit to non-information traders, such as small

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41. While a detailed discussion of shareholder wealth maximization as the corporate objective is beyond the scope of this paper, some discussion is warranted on why shareholder wealth maximization is more desirable than a stakeholder approach. First, unlike a stakeholder approach where the board of directors is given the impossible task of balancing the interests of multiple stakeholders without maximizing the interests of any, shareholder wealth maximization allows for the maximization of an objective function. Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14 J. APPL. CORP. FIN. 8 (2001). As stated by Professor Michael Jensen: "It is logically impossible to maximize in more than one dimension at the same time unless the dimensions are . . . 'monotone transformations' of one another." *Id.* at 10–11. If a stakeholder approach is taken, then "[t]he result will be confusion and lack of purpose that will [fundamentally] handicap the firm in its competition for survival." *Id.* at 11 (footnote omitted). Again, according to Professor Jensen: "[W]hereas value maximization provides corporate managers with a single objective, stakeholder theory directs corporate managers to serve 'many masters.' And, to paraphrase the old adage, when there are many masters, all end up being shortchanged." *Id.* at 9. Second, according to Judge Frank Easterbrook and Professor Daniel Fischel, one can think of shareholder wealth maximization as the default rule under corporate law because it is "the operational assumption of successful firms." FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 36 (1991). Third, shareholder wealth maximization benefits all stakeholders because the striving for profits means that the contractual demands of non-shareholders must first be met before there is any residual profit available for distribution to shareholders. *Id.* at 36–38. Fourth, as residual claimants, shareholders take on the "residual risk, [i.e.] the risk of the difference between stochastic inflows of resources and promised payments to agents" and in exchange, receive the right to receive the net cash flows of the corporation. Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 302 (1983). Since shareholders bear risks from discretionary decisions, the corporation made, shareholders would require shareholder wealth maximization as part of the hypothetical bargain with the firm's other parties. EASTERBROOK & FISCHEL, *supra* at 67–68. Fifth and finally, shareholder wealth maximization allows for a "unity of purpose . . . between [directors and] shareholders who seek to correct managerial efficiencies through shareholder activism" or the market for corporate control. Sharfman, *Activist Hedge Funds*, *supra* note 3, at 118. "While there may be disagreement between shareholders and the board of directors regarding the correct strategy the corporation should implement," the price the company should be sold or whether the company should be sold at all, "at least there will be disagreement on the ultimate corporate objective, giving the company the best opportunity to correct managerial inefficiencies." *Id.*

investors, as takeovers, whether friendly or not, provide spillover effects in the form of higher stock prices for all shareholders.[42] According to Manne, "[o]nly the take-over scheme provides some assurance of competitive efficiency among corporate managers and thereby affords strong protection to the interests of vast numbers of small, non-controlling shareholders."[43]

II. CORPORATE LAW AND THE MARKET FOR CORPORATE CONTROL

Assuming that the objective of corporate law is to facilitate the default objective of corporate governance, shareholder wealth maximization, then corporate law has done its job, at least in the context of the market for corporate control. It does this through a very permissive approach to acquisitions, whether the acquisition is hostile or friendly, and whether the purpose is to correct managerial efficiencies, reduce competition, acquire economies of scale without internal growth, or maximize monopoly rents.

In a friendly acquisition, the type of acquisition that has dominated the market for the past twenty-five years,[44] being a member of the target company's board of directors is no longer possible given that the target has been merged out of existence, or the existing board members of the target will simply agree to resign if the target company survives as a legal entity.[45] The result is that the acquirer can nominate and vote to elect its board nominees without resistance. However, acquiring control for purposes of increasing managerial efficiency has little value if the acquirer cannot easily and with minimal cost implement its desired corporate strategies. Therefore, corporate law must make sure that the acquirer's strategies can be implemented without interference from minority shareholders, if they exist, or other stakeholders such as creditors, vendors or the courts.

First and foremost, corporate law does this by making it a default rule that all decision making must flow through the board of directors.[46] That is, "corporate law provides a public company's

42. *See* Manne, *Mergers & the Market*, *supra* note 8, at 113.

43. *Id.*

44. The percentage of friendly acquisition activity has averaged above 89% since the late 1980s. Cain et al., *supra* note 21, at 10.

45. DEL. CODE ANN. tit. 8, §§ 251–261 (2015).

46. The Delaware General Corporation Code provides, "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." DEL. CODE ANN. tit. 8, § 141(a) (2015).

Board the exclusive authority to manage and execute the various forms of explicit and implicit contracts that encompass a firm's contractual makeup."[47] While the Board has fiduciary duties to the minority shareholders, if they still exist after control has been acquired, other stakeholders such as customers, vendors, employees, or creditors, assuming there are no issues of insolvency[48] or bankruptcy, have no standing to stop their implementation beyond what is owed to them under contract. Moreover, if minority shareholders exist and they challenge a Board decision that does not involve a self-dealing transaction,[49] then the decision is protected by the business judgment rule.[50]

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47. Rose & Sharfman, *supra* note 1, at 1022 (footnote omitted) (citation omitted).

48. When a corporation is insolvent, "the creditors . . . have standing to maintain derivative claims [but not direct claims] against directors on behalf of the corporation for breaches of fiduciary duties." N. Am. Catholic Educ. Programming Found. Inc. v. Gheewalla, 930 A.2d 101, 102 (Del. 2007) (footnote omitted) (citation omitted).

49. In general, a self-dealing transaction between the controlling shareholder and the company will be reviewed under an entire fairness standard of review. *See* Kahn v. Lynch Comm. Sys., Inc., 638 A.2d 1110 (Del. 1994). Of course, there are always exceptions to the rule. *See* Kahn v. M&F Worldwide Corp., 88 A.3d 635, 644–45 (Del. 2014) (allowing for the business judgment rule to apply to freeze-out mergers when "the merger is conditioned *ab initio* upon the approval of both an independent, adequately-empowered Special Committee that fulfills its duty of care, and the uncoerced, informed vote of a majority of the minority stockholders"). *See also* Bernard S. Sharfman, *Kahn v. M&F Worldwide Corporation: A Small but Significant Step Forward in the War Against Frivolous Shareholder Lawsuits*, 40 J. CORP. L. 197 (2014) (arguing that little has changed for the defendant under *Kahn*'s exception).

50. According to the Delaware Chancery Court in *Robotti v. Gulfport Energy Corp.*:

> The business judgment rule, as a general matter, protects directors from liability for their decisions so long as there exists "a business decision, disinterestedness and independence, due care, good faith and no abuse of discretion and a challenged decision does not constitute fraud, illegality, ultra vires conduct or waste." There is a presumption that directors have acted in accordance with each of these elements, and this presumption cannot be overcome unless the complaint pleads specific facts demonstrating otherwise. Put another way, under the business judgment rule, the Court will not invalidate a board's decision or question its reasonableness, so long as its decision can be attributed to a rational business purpose.

No. 3128-VCN, slip op. at 31–32 (Del. Ch. Jan. 14, 2010) (citing STEPHEN A. RADIN ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES FOR CORPORATE

In addition, the presence of a controlling shareholder eliminates the uncertainty of gaining shareholder approval when the Board decides to make a significant acquisition.[51] The default rule for majority shareholder approval of significant acquisitions provides the controller the opportunity to dramatically increase the size of the corporation if it believes that is what is necessary to enhance efficiency.[52] Such a decision is a function of transaction costs and the marginal analysis that goes into determining whether it is better to produce what it needs internally under a command and control structure, and thereby potentially grow to great size through internal investment or acquisitions, or simply purchase from external sources.[53] Conversely, the majority default rule also eliminates the uncertainty of shareholder approval when the controlled Board decides to make the bold move of selling off "substantially all of its property and assets."[54]

Corporate law clearly takes a "property rights" approach to corporate governance when a controlling shareholder is present.[55] Once the acquirer has control of the Board, new strategies may be implemented to enhance managerial efficiency. In sum, those who participate in the market for corporate control benefit from a corporate law that is very willing to help them reach their goal of

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DIRECTORS 110 (6th ed. 2009)). Therefore, if the preconditions of the business judgment rule are met, the defendants escape a substantive review of the decision. *Id.* It should also be noted that due care is process due care only, not substantive due care. Brehm v. Eisner, 746 A.2d 244, 262–64 (Del. 2000). To establish a breach in the duty of care and thereby overcome the business judgment rule, the plaintiff must make a showing that the directors were grossly negligent when becoming informed in making a business decision. *See* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

51. DEL. CODE ANN. tit. 8, § 251(c) (2015).

52. *See* Bernard S. Sharfman, *Why Proxy Access is Harmful to Corporate Governance*, 37 J. CORP. L. 387, 396 (2012) (discussing default rules for shareholders).

53. *Id.* at 396 (citing Ronald H. Coase, *The Nature of the Firm*, in 16 ECONOMICA 386, 393–97 (1937)). Under a Coasean framework, "managers continuously compare the incremental costs and payoffs of internal production (expansion or vertical integration) against external procurement, chosing [sic] whichever alternative provides the best payoff until the two are equalized at the margin." Herbert Hovenkamp, *Coasean Markets*, 31 EUR. J.L. & ECON. 63, 68 (2011). The point of optimal firm size, which means the corporation may become very large in size, is a function of this marginal analysis. *See id.* at 71.

54. DEL. CODE ANN. tit. 8, § 271 (2015).

55. The property rights approach gives one party "a residual right of control over the assets used in the joint enterprise." *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 260 (1999). In this case, the party that is given a residual right of control over the assets of the corporation is the controlling shareholder.

maximizing shareholder wealth through correcting managerial inefficiencies.

III. A THEORY OF SHAREHOLDER ACTIVISM

Shareholder activism refers to "any action(s) of any shareholder or shareholder group with the purpose of bringing about change within a public company *without trying to gain control.*"[56] Shareholder activism exists in a "market for corporate *influence.*"[57] That is, shareholder activists are trying to influence corporate decision-making without spending the resources necessary to gain control.[58]

A. The Thesis

Utilizing Manne's premise that there exists "a high positive correlation between corporate managerial efficiency and the market price of shares of that company,"[59] a new argument, such as the following, can be made: "In the context of public companies, shareholder activism may constitute a valuable asset in and of itself if the goal of such activism is to enhance managerial efficiency."[60]

Such an argument assumes that the activist holds enough shares in the company to earn a large enough return on the expected

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56. Rose & Sharfman, *supra* note 1, at 1015. Professor Andreas Jansson describes shareholder activism, in part, as the action of outside shareholders who "influence corporate insiders . . . by voicing their opinions in order to affect corporate behavior." Andreas Jansson, *No Exit!: The Logic of Defensive Shareholder Activism*, 10 CORP. BD: ROLE, DUTIES & COMPOSITION 16 (2014).

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

58. Professors Stuart Gillian and Laura Starks note: "Shareholder activists are often viewed as investors who, dissatisfied with some aspect of a company's management or operations, try to bring about change within the company without a change in control." Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, 19 J. APPL. CORP. FIN. 55, 55 (2007).

59. Manne, *Mergers & the Market*, *supra* note 8, at 112.

60. As observed by Jansson, "[I]t is widely believed that shareholder activism is a means by which outside shareholders discipline inefficient management teams." Jansson, *supra* note 56, at 16.

increase in the stock price to cover the costs of its activism. In addition, it should be assumed that shareholder activism for the purpose of correcting managerial inefficiencies has the objective of increasing shareholder wealth. Therefore, our discussion does not include activism targeted to implementing social change at the corporate entity and whatever benefits or costs to society that may result from those actions.

This type of shareholder activism targeted at increasing corporate performance and ultimately raising the price of the target's publicly traded stock provides a corrective function similar to, but far less radical than, what is found in the market for corporate control.[61] Moreover, unlike the market for corporate control, the market for corporate influence does not have to concern itself with the desire of its participants to reduce competition, acquire monopoly rents, or generate economies of scale without making internal investments.[62] From that perspective, the intent of its participants should be much less suspect than those participating in the market for corporate control.

Like the market for corporate control, shareholder activists operate in a market where, assumably, a vast majority or at least a significant number of information traders will not become proactive and take on an active role in seeking to implement managerial efficiencies. In general, these information traders would prefer to "vote with their feet"[63] rather than participate in the market for corporate influence.[64] Again, they are value investors,[65] devoting whatever limited time, resources, and skill they have to valuation, not to correcting managerial inefficiencies.[66]

Also, because a shareholder activist must absorb all the costs of his activism privately, but share the benefits with all other shareholders, giving shareholder activism the attributes of a public good, the shareholder activist must have a significant investment in the target company to enhance the odds the activism will lead to the

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61. *See id.* at 17.

62. *See* Johnathan R. Macey, *Market for Corporate Control*, The Concise Encyclopedia of Economics (2008), http://www.econlib.org/library/Enc/Marketfor CorporateControl.html (last visited Dec. 15, 2015) (discussing competition and the market for corporate control).

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

64. Rose & Sharfman, *supra* note 1, at 1016.

65. *Id.* (citation omitted).

66. *Id.*

requested changes, as well as making it profitable.[67] In addition, the taking on of a significant investment in the target company, even though not trying to gain voting control, may lead to an overweighting of the stock and a reduction in the benefits of portfolio diversification. All these issues contribute to the expectation that a significant number of information traders prefer to vote with their feet.[68]

However, as in the market for corporate control, it can be envisioned that there will be some information traders who will be incentivized to become shareholder activists and take advantage of price drops caused by value investors selling their shares. These shareholder activists will proactively seek managerial efficiencies but without seeking control.

B. *The Offensive Shareholder Activist*

The offensive shareholder activist has been identified as the type of information trader that fits the role of a shareholder activist seeking to correct managerial inefficiencies.[69] Numerous empirical studies have demonstrated that this type of activism leads to higher stock prices and better company performance.[70]

Offensive shareholder activism, as identified by John Armour and Brian Cheffins, is performance-driven activism initiated primarily by a specific type of institutional investor: the hedge fund.[71] As described in the Timken example found in Section C of this Part, it typically begins with a hedge fund, an unregulated investment fund, accumulating a significant amount of a company's stock.[72] The hedge fund makes its purchases based on a determination that the target company is currently not maximizing returns and that if management would change its strategies to what the hedge fund believes is correct, then company performance will improve, the stock will increase in value, and the hedge fund will earn excess returns on its investment.[73] Thus, offensive shareholder activism targets the correction of managerial inefficiencies in the same manner as acquirers do in the market for corporate control, but without ever attempting or gaining control of the company.

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67. Jansson, *supra* note 56, at 16–17.

68. *Id.* at 17.

69. Rose & Sharfman, *supra* note 1, at 1033–34.

70. *See* Brav et al., *Hedge Fund Activism, Corporate Governance*, *supra* note 5.

71. Rose & Sharfman, *supra* note 1, at 1034 (footnote omitted) (citation omitted).

72. *See* Cheffins & Amrour, *supra* note 57, at 56.

73. *Id.* at 56–57.

Empirical studies of offensive shareholder activism, commonly referred to as hedge fund activism, are striking in how they support the thesis of shareholder activism and the description of a subgroup of information traders attempting to exploit Manne's premise of a low stock price being a reflection of managerial inefficiencies.[74] According to Alon Brav, Wei Jiang, and Hyunseob Kim:

> The significant coefficients on the valuation variable, q (defined as (book value of debt + market value of equity)/(book value of debt +book value of equity)), indicate that the activist hedge funds resemble "value investors." This result suggests that activist hedge funds are attempt[ing] to identify undervalued companies where the potential for improvement is high. In fact, in about two-thirds of the cases, the hedge fund explicitly states that it believes the target is undervalued. To the extent that activist hedge funds profit from the improvement of the companies' operations and strategies, it is also important that hedge funds target companies whose stock prices have yet to reflect the potential for improvement.[75]

Moreover, "the targets of hedge fund activism exhibit relatively high trading liquidity, institutional ownership, and analyst coverage . . . [that] allow the activist investors to accumulate significant stakes in the target firms quickly without adverse price impact, and to get more support for their agendas from fellow sophisticated investors."[76]

However, significant wealth enhancement has only been found where offensive shareholder activism has led to "the sale of the company or changes in business strategy, such as refocusing and spinning-off noncore assets."[77] According to Brav, Jiang, Partnoy, and Thomas:

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74. Sharfman, *Activist Hedge Funds*, *supra* note 3, at 102 (citing Brav et al., *Hedge Fund Activism, Corporate Governance*, *supra* note 5).

75. Alon Brav, Wei Jiang and Hyunseob Kim, *Hedge Fund Activism: A Review*, 4 FOUNDATIONS AND TRENDS IN FINANCE 185, 207 (2009), *available at* https://faculty.fuqua.duke.edu/~brav/RESEARCH/papers_files/BravJiangKim2010.pdf.

76. *Id.* at 188.

77. Boyson & Mooradian, *supra* note 5, at 178; Brav et al., *Hedge Fund Activism, Corporate Governance*, *supra* note 5, at 1731; *see also* Clifford, *supra* note 5, at 324 (proposing that firms targeted by hedge funds for active purposes yield better returns than firms targeted for passive purposes); Greenwood & Schor, *supra* note 5, at 374 (finding activists most successful at creating value when they can force a change in control); Klein & Zur, *supra* note 5, at 217 (noting that both activist hedge funds and entrepreneurial investors produced average abnormal returns).

> [Hedge fund] [a]ctivism that targets the sale of the company or changes in business strategy, such as refocusing and spinning-off noncore assets, is associated with the largest positive abnormal partial effects . . . . In contrast, we find that the market response to capital structure-related activism—including debt restructuring, recapitalization, dividends, and share repurchases—is positive yet insignificant. We find a similar lack of statistically meaningful reaction for governance-related activism—including attempts to rescind takeover defenses, to oust CEOs, to enhance board independence, and to curtail CEO compensation.[78]

In addition, recent research suggests we can delve even further and find that while both experienced and inexperienced offensive shareholder activists create significant wealth and performance enhancement within a corporation, experienced activists do better than inexperienced activists.[79] Most importantly, the abnormal positive returns associated with offensive shareholder activism do not dissappear over time. Studies by Boyson and Mooradian[80] and Brav, Jiang, Partnoy, and Thomas[81]

> have demonstrated that the short-term run-up in stock prices from hedge fund activism persists for at least a year after the filing of a Schedule 13D. [In addition,] a recent study by Bebchuk, Brav, and Jiang has shown that hedge fund activism does not result in abnormal negative returns over a five-year period.[82]

This indicates that, on average, the corrective strategies being implemented by offensive shareholder activism are enhancing shareholder wealth consistent with the thesis presented in this Part.

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78. Brav et al., *Hedge Fund Activism, Corporate Governance*, *supra* note 5, at 1731.

79. Nicole M. Boyson, Linlin Ma & Robert Mooradian, *Are All Hedge Fund Activists Created Equal? The Impact of Experience on Hedge Fund Activism* 1 (Mar. 21, 2014) (unpublished manuscript) (on file with author) ("[O]ur results imply that more experienced activists deliver better short-term performance and long-term outcomes for target firms.").

80. Boyson & Mooradian, *supra* note 5.

81. Brav et al., *Hedge Fund Activism, Corporate Governance*, *supra* note 5.

82. Rose & Sharfman, *supra* note 1, at 1041 (citing Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1126–27 (2015)).

C. An Example of Offensive Shareholder Activism

Shareholders who participate in offensive shareholder activism are information traders that "take large positions in public companies as a means to effect change."[83] They are distinguished from the typical information trader by their willingness to spend resources to identify strategic changes that they believe will increase the share price of the targeted public company and then spend even more resources to try to get the company to implement those changes.[84]

Offensive shareholder activism[85] begins with an institutional investor, typically a hedge fund, identifying a public company that it believes is underperforming and what needs to be done to cure the target's managerial inefficiencies.[86] It then begins to accumulate a significant amount of that company's voting common stock.[87] Once the accumulation has been accomplished, perhaps 5 to 10% of the target's voting common stock, it then begins to advocate—first in private with the target's Board and executive management, then publicly if necessary—what needs to be done to significantly increase the price of the target's stock.[88]

The Board is now put in a difficult position. It must determine who has the best advice for moving the company forward under the following conditions: "[The] executive management team may resist the activist's proposals no matter how meritorious simply because of reputational concerns, while the activist may threaten a proxy contest [even if the Board determines] in good faith that the activist's recommendations will not correct managerial inefficiencies."[89]

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83. Bernard S. Sharfman, *What's Wrong with Shareholder Empowerment?*, 37 J. CORP. L. 903, 906–07 (2012) [hereinafter Sharfman, *Shareholder Empowerment*].

84. *Compare* Cheffins & Armour, *supra* note 57, at 56–57, *with* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1050 (2007).

85. It appears that Andreas Jansson was the first to coin this phrase but with a different intent. Andreas Jansson, *Types of Shareholder Activism: Offensive Opportunity Seizure or Defensive Safeguarding of the Investment?* (EAA 30th Annual Conference at Lisbon, Conference paper (2007)).

86. Cheffins & Armour, *supra* note 57, at 56.

87. *See id.*

88. Kahan & Rock, *supra* note 84, at 1088. Offensive shareholder activism is distinct from "defensive shareholder activism," which refers to institutional investors that hold significant blocks of company stock and advocate for changes only when company fortunes decline. *Id.* (citations omitted).

89. Sharfman, *Activist Hedge Funds*, *supra* note 3, at 127; *see also* Jonathan B. Cohn and Uday Rajan, *Optimal Corporate Governance in the Presence of an Activist*

The following example demonstrates how offensive shareholder activism is implemented:

> In early 2012, Relational Investors LLC (Relational) began accumulating shares of the Timken Co. (NYSE: TKR). By June 30, 2012, it had acquired approximately $65 million of Timken stock, and by September 30, 2012, it had increased its holdings to approximately $120 million. On August 23, 2012, Relational made its first reported presentation to the company's board, urging the board to split the company into two, with one part focusing on steel production and the other on ball bearings. This [non-binding] proposal was met with strong opposition from the board. California State Teachers' Retirement System (CalSTRS), in coordination with Relational, placed a non-binding resolution in the company's annual meeting proxy materials that called for such a split. The non-binding proposal was approved by a 53% majority of Timken shareholders at the annual shareholders meeting held May 7, 2013. As a result, the Timken board announced on June 10, 2013 that it had formed a[n] independent [committee] to evaluate such a separation of businesses. . . . On September 5, 2013, the Board of Timken "approved a plan to separate the Company's steel business from its bearings and power transmission business through a spinoff." . . . On June 30, 2014, Timken distributed 100% of its interest in its steel operations to the holders of the company's common stock.[90]

TimkenSteel was now formed. By the fall of 2014, Relational had sold its "entire position in both Timken and TimkenSteel."[91] Relational was reported to have earned $188 million on its investment, a 75% gain in an investment horizon covering a little over two years.[92]

Timken's elimination of its staggered board helped Relational in its quest to pressure the Timken Board into spinning off its steel business.[93] This process began in 2010[94] and was completed just in

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Investor, 26 REV. FIN. STUDIES 985, 986 (2013).

90. Rose & Sharfman, *supra* note 1, at 1035–36 (footnotes omitted) (citations omitted).

91. Nelson D. Schwartz, *How Wall Street Bent Steel: Timken Bows to Activist Investors, and Splits in Two*, N.Y. TIMES, (Sept. 23, 2015, 9:09 PM), http://www.nytimes.com/2014/12/07/business/timken-bows-to-investors-and-splits-in-two.html.

92. *Id.*

93. *See* TIMKEN CO., 2010 AMENDED REGULATIONS 3 (MAY 11, 2010), http://www.sec.gov/Archives/edgar/data/98362/000095012310073349/l40275exv3w1.htm.

94. *Id.*

time for Timken's 2013 annual meeting,[95] the same meeting where shareholders voted on spinning off the steel business.[96] For an offensive shareholder activist, the importance of not having to face a staggered board cannot be overstated. The threat of a proxy contest to take control of the Board, facilitated by the absence of a staggered Board, is usually an important component in the offensive shareholder activist's arsenal of weapons to implement change.[97] As pointed out by professors John Coffee and Darius Palia, "A threat to sell the company or fire the CEO is an empty one if the activist faces a staggered board and can only elect one third of the directors at the next annual election."[98] Fortunately for offensive shareholder activists, there has been a rapid decline in staggered boards over the past decade and a half.[99] According to Coffee and Palia, "[i]n 2000, 300 of the S&P 500 [public companies] had staggered boards, but as of the end of 2013, only 60 did."[100]

Losing the spin-off vote must have made the Board realize it was in jeopardy of losing a proxy contest at the next annual meeting, meaning that the spin-off would eventually take place with or without the current sitting Board members. Even so, if the Board had an adequate degree of independence from both management and shareholders, and if the Board felt strongly enough as a group that such a spin-off was not in the best interest of the corporation and its shareholders, then it still could have fought the idea by making its case to the shareholders and risking a proxy contest for control of the Board.[101] However, that did not happen. Moreover, what probably helped win the day for Relational was that its proposal for splitting the company was very precise, making it easier for the Board and all of the company's shareholders to understand the costs and benefits

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95. *See* TIMKEN CO., 2013 NOTICE OF ANNUAL MEETING OF SHAREHOLDERS AND PROXY STATEMENT 5, http://www.timken.com/en-us/investors/FinancialReports/Documents/Timken-2013-Proxy-Statement.pdf.

96. *Id.* at 48.

97. *See* John C. Coffee, Jr. & Darius Palia, *The Impact of Hedge Fund Activism: Evidence and Implications* 3–4 (Colum. L. Sch., Center for L. & Econ. Stud., Working Paper No. 489, 2014), *available at* http://www.shareholderforum.com/access/Library/20140915_Coffee&Darius.pdf.

98. *Id.* at 13–14.

99. *Id.* at 14.

100. *Id.* (citing David Benoit, *Clash Over Board will be Measure of Activist Clout*, WALL ST. J., May 23, 2004, at C-1).

101. For a more in-depth discussion of the role played by Board independence in offensive shareholder activism, see Sharfman, *Activist Hedge Funds*, *supra* note 3, at 126–28.

involved and demonstrating that Relational had the reputation of being a very successful offensive shareholder activist.[102]

Rose and Sharfman argued that the Timken example was representative of the type of shareholder activism that can be understood as a corrective mechanism in corporate governance.[103] This argument was based on Kenneth Arrow's theory of large organizations.[104] Arrow pointed out that it is important from time to time to allow a part of the organization that is not the centralized authority to significantly influence corporate decisions.[105] According to Arrow, decision-making "[e]rror is unnecessary when the information is available somewhere in the organization but not available to or not used by the authority. That is, others in the organization may have access to superior information or insights on at least some matters."[106] Therefore, it is legitimate to criticize such authority, allowing for a corrective mechanism when necessary.[107] In the context of a public company, the part of the organization that may legitimately question the authority of the Board or executive management[108] is the offensive shareholder activist (usually a hedge fund), an individual or entity that may have superior information or insights in certain discrete situations.[109]

IV. THE PRESUMPTION OF BOARD SUPERIORITY IN DECISION MAKING

This article takes as a given the presumption that the Board is the locus of authority in a public company and is in the best position to make the most important decisions on behalf of the company, including when to delegate decision-making authority to executive management. Nevertheless, a fair question to ask is where does this presumption come from? Also, is that presumption correct?

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102. *See* Cohn & Rajan, *supra* note 89.

103. Rose & Sharfman, *supra* note 1, at 1035–37.

104. *Id.* at 1020.

105. KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 74–75 (1974).

106. *Id.*

107. *Id.* Arrow provides the somewhat humorous example of Cromwell dealing with the Scottish authority and then being the locus of authority himself: "Cromwell reminded the Scottish authority, 'I beseech you, in the bowels of Christ, think it possible you may be mistaken.' Cromwell, in his turn, was not much disposed to admit the possibility that others might know enough to correct him." *Id.*

108. For a more in-depth discussion of the role played by the activist hedge fund in challenging the authority of executive management, an authority delegated to it by the Board, *see* Sharfman, *Activist Hedge Funds*, *supra* note 3.

109. Rose & Sharfman, *supra* note 1, at 1037.

A. *The Source of the Presumption*

Not surprisingly, corporate law is the source of that presumption. Corporate law supports what Michael Dooley would call an "Authority Model"[110] and Stephen Bainbridge would call a "Director Primacy"[111] approach to corporate governance. It does so by providing numerous statutory default rules and court opinions that provide the board of directors with ultimate decision-making authority in a corporation, the corporate form overwhelmingly favored by public companies.[112] Most importantly, statutory corporate law makes the board of directors the default locus of authority for corporate decision-making.[113] Statutory corporate law vests in directors the power to control corporate assets,[114] including the payment of dividends and other distributions.[115] To facilitate a centralized, hierarchical management structure, corporate law allows the board to delegate significant amounts of its decision-making authority to its executive officers.[116] This Board-designated locus of authority "not only runs the company on a day-to-day basis but also provides the Board with recommendations on what investment projects and strategies the company should proceed with and then implements them with Board approval."[117] This delegation of authority is most important in a modern public company where it is very typical to find a Board composed of very

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110. Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 463 (1992). Dooley referred to two models of corporate governance, the "Authority Model" and the "Responsibility Model." The Authority Model dominates corporate law. *Id.* In *Two Models of Corporate Governance*, Professor Michael Dooley was the first to make the connection between the work of Kenneth Arrow and the structure of Delaware corporate law. *Id.* at 467.

111. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 550 (2003) [hereinafter Bainbridge, *Director Primacy*]; *see also* Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1 (2002) [hereinafter Bainbridge, *Board as Nexus*].

112. Bainbridge, *Director Primacy*, *supra* note 111, at 559.

113. Delaware General Corporation Law Section 141(a) states: "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." DEL. CODE ANN. tit. 8, § 141(a) (2015).

114. *Id.* at § 141(c)(1).

115. DEL. CODE ANN. tit. 8, § 170(a) (2015).

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

117. Sharfman, *Activist Hedge Funds*, *supra* note 3, at 121.

few insiders.[118] Moreover, it is the Board who decides what authority is to be delegated and which executive officers to hire and fire.[119]

In regard to corporate decision making, the Board is not required to follow the commands of its shareholders, even if shareholders pass a unanimous resolution requesting the Board to act in a specific manner.[120] Shareholders may ratify a Board's action, but the Board must first approve the action.[121] If the Board decides to sell corporate assets, it only needs to seek shareholder approval if selling off "substantially all of its property and assets."[122] If the Board decides to make an acquisition, it does not need to seek shareholder approval if the existing shareholders are not diluted by more than 20% or if it makes the acquisition using cash.[123] Finally, subject to shareholder approval, the Board has sole discretion to initiate changes to the corporate charter.[124]

The courts also support this presumption through holdings and dicta. First and foremost, common law protects the decisions of the Board from shareholder challenge and to a great extent, immunizes the directors from individual liability by applying the "business judgment rule" to even the Board's most inept business decisions.[125]

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118. According to a recent report by Spencer Stuart, 84% of S&P 500 Boards were composed of independent directors. Spencer Stuart, 8 *SPENCER STUART BOARD INDEX* 2014, https://www.nyse.com/publicdocs/nyse/listing/Spencer_Stuart_Board_Index_2014.pdf. Moreover, "the CEO has become the sole non-independent director on the majority of boards. On 58% of boards today, the CEO is the only non-independent director, compared with 50% in 2009. In 2004, 61% of boards had at least one non-independent director in addition to the CEO." *Id.* at 15.

119. Sharfman, *Shareholder Empowerment*, *supra* note 83, at 905.

120. DEL. CODE ANN. tit. 8, § 141(a) (2015); *see also*, Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) ("A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation."), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000).

121. For example, when a corporation has decided to proceed with a merger proposal, the statutory process requires that the board of directors take the lead by initiating the proposal with the shareholders participating by voting on the proposal. DEL. CODE ANN. tit. 8, § 251(b)-(c) (2015).

122. DEL. CODE ANN. tit. 8, § 271(a) (2015).

123. DEL. CODE ANN. tit. 8, § 251(f) (2015).

124. DEL. CODE ANN. 8, § 242(b)(1) (2015). In certain states, shareholders may amend the corporate charter without board approval. For example, *see* OHIO REV. CODE ANN. § 1701.71(A)(1) (LexisNexis 2014).

125. Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 271 (1967). According to Henry G. Manne, the business judgment rule "will preclude the courts from any consideration of honest if inept business decisions, and that seems to be the purpose of the rule." *Id.*

As stated by the Delaware Supreme Court in *Zapata Corp. v. Maldonado*:

> The "business judgment" rule is a judicial creation that presumes propriety, under certain circumstances, in a board's decision. Viewed defensively, it does not create authority. In this sense the "business judgment" rule is not relevant in corporate decision making until after a decision is made. It is generally used as a defense to an attack on the decision's soundness. The board's managerial decision-making power, however, comes from § 141(a). The judicial creation and legislative grant are related because the "business judgment" rule evolved to give recognition and deference to directors' business expertise when exercising their managerial power under § 141(a).[126]

Moreover, according to Dooley and former Delaware Supreme Court Chief Justice Norman Veasey:

> The power to hold to account is the power to interfere and, ultimately, the power to decide. If stockholders are given too easy access to courts, the effect is to transfer decision-making power from the board to the stockholders or, more realistically, to one or a few stockholders whose interests may not coincide with those of the larger body of stockholders. By limiting judicial review of board decisions, the business judgment rule preserves the statutory scheme of centralizing authority in the board of directors. In doing so, it also preserves the value of centralized decision making for the stockholders and protects them against unwarranted interference in that process by one of their number. Although it is customary to think of the business judgment rule as protecting directors from stockholders, it ultimately serves the more important function of protecting stockholders from themselves.[127]

This hands-off approach to Board decision making can only be overcome if a plaintiff shareholder can demonstrate that the decision was "tainted with a conflict of interest, lack of independence or gross

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126. Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981) (footnotes omitted).

127. Michael P. Dooley & Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 522 (1989).

negligence [process only]"[128] and "where exculpation clauses[129] do not apply."[130]

In addition, shareholders are required to make a demand before filing a derivative suit or must demonstrate demand futility.[131] The Board also has the right to implement defensive measures to ward off an unwelcome takeover bid under the *Unocal* test, even when a majority of shareholders may be willing to accept the bid.[132] Even more impressive, the Board has the right to implement a shareholder rights plan poison pill without shareholder approval even when there is no immediate takeover threat.[133]

These statutory default rules, holdings, and dicta, which concentrate decision making in the board of directors, are what separate and distinguish the corporate form from all other legal entities, such as the limited liability company ("LLC").

B. Is the Presumption Correct?

Corporate law concentrates decision-making authority in the Board and executive management because it recognizes that a centralized, hierarchical authority is necessary for the successful management of a public company that can become extremely large in size.[134] According to Professor Robert Clark, hierarchies in large organizations lead to the "facilitation of cooperation in the carrying out of large-scale tasks."[135] According to Kenneth Arrow, information scattered over a large organization must be both filtered and transmitted to a centralized authority in order for a large organization to make informed decisions and minimize error in decision making.[136]

Professors Alan Alchian and Harold Demsetz argued that hierarchies arise as a way to solve the problems of shirking in the context of team production where all team members expect to benefit from the success of their mutual endeavors but where it is hard to

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128. Bernard S. Sharfman, *Shareholder Wealth Maximization and its Implementation under Corporate Law*, 66 FLA. L. REV. 389, 390 (2014) [hereinafter Sharfman, *Shareholder Wealth Maximization*].

129. DEL. CODE ANN. tit. 8, § 102(b)(7) (2015).

130. Sharfman, *Shareholder Wealth Maximization*, *supra* note 128, at 392.

131. DEL. CH. CT. R. 23.1(a); Aronson v. Lewis, 473 A.2d 805, 807–08 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (2000).

132. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955–56 (Del. 1985).

133. Moran v. Household Int'l, Inc., 500 A.2d 1346, 1353 (Del. 1985).

134. ROBERT CHARLES CLARK, CORPORATE LAW app. at 801–16 (1986) (arguing that "facilitation of cooperation" allows for efficiently completing large tasks).

135. *Id.*

136. ARROW, *supra* note 105, at 68–70.

value individual contributions.[137] This would appear applicable to a public company, where an independent board of directors could perform the role of monitoring the performance of the executive management team.[138]

Alchian and Demsetz also argued that a centralized authority was necessary to eliminate the problems associated with having a large number of shareholders:

> If every stockowner participated in each decision in a corporation, not only would large bureaucratic costs be incurred, but many would shirk the task of becoming well informed on the issue to be decided, since the losses associated with unexpectedly bad decisions will be borne in large part by the many other corporate shareholders. More effective control of corporate activity is achieved for most purposes by transferring decision authority to a smaller group, whose main function is to negotiate with and manage (renegotiate with) the other inputs of the team.[139]

Michael Dooley observed that the value of centralized authority in an organization, such as in a public company, is magnified as the knowledge and interests of its members diverge.[140] In a public company, information and interests differ between management and shareholders.[141] Especially where there are a large number of shareholders, it is much more efficient, in terms of maximizing shareholder value, for the Board and executive management—the corporate actors that possess overwhelming advantages in terms of information, including nonpublic information, and whose skills in the management of the company are honed by specialization in the

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137. Alchian & Demsetz, *supra* note 32, at 781. According to Alchian and Demsetz: "With team production it is difficult, solely by observing total output, to either define or determine each individual's contribution to this output of the cooperating inputs. The output is yielded by a team, by definition, and it is not a sum of separable outputs of each of its members." *Id.* at 779 (emphasis in original).

138. *Id.* at 781. ("One method of reducing shirking is for someone to specialize as a monitor to check the input performance of team members."); *see also*, Sharfman, *Activist Hedge Funds*, *supra* note 3, at 127.

139. Alchian & Demsetz, *supra* note 32, at 788.

140. Dooley, *supra* note 110, at 467 ("Where the residual claimants are not expected to run the firm and especially when they are many in number (thus increasing disparities in information and interests), their function becomes specialized to risk-bearing, thereby creating both the opportunity and necessity for managerial specialists.").

141. *Id.* at 466–67.

management of this one company—to make corporate decisions rather than shareholders.[142]

Yes, corporate law does provide tools of accountability to minimize opportunistic behavior by the Board. For example, shareholders can file derivative and direct suits claiming that the directors have breached their fiduciary duty of loyalty or duty of care, or both. Or, shareholders can pursue a proxy contest to replace one or more sitting directors. However, these tools of accountability do not provide recognition by corporate law that there is another locus of authority outside the board of directors and executive management, such as an activist hedge fund, that should be recognized as a locus of authority in corporate decision making.

In sum, corporate law's statutory default rules, judicial opinions, dicta, and the various theories of the firm just described provide the necessary justification and make reasonable Professor Stephen Bainbridge's statement that the "[p]reservation of managerial discretion should always be the null hypothesis."[143]

However, that is not the end of the story. The next question that needs to be asked is how corporate law should deal with offensive shareholder activism, a non-statutory locus of authority, unlike the Board's and executive management's authority,[144] that challenges corporate law's presumption that the Board or, by Board delegation, its executive management team, is in the best position to make the major corporate decisions.

V. CORPORATE LAW AND OFFENSIVE SHAREHOLDER ACTIVISM

As already discussed, corporate law treats acquirers, including those who participate in the market for corporate control, with great reverence, not distinguishing between or caring what the motivations may be behind the acquisitions: be it reduction of competition, efficiency, economies of scale, or monopoly rents. Most importantly, corporate law provides a clear path for acquirers to correct managerial inefficiencies. While the board of directors is the ultimate locus of authority for corporate decision making, the controlling shareholder controls the Board and what strategies it ultimately implements.[145] There is a presumed unity of interest

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142. *Id.*

143. Steven M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 109 (2004) [hereinafter Bainbridge, *The Business Judgment Rule*].

144. Sharfman, *Activist Hedge Funds*, *supra* note 3, at 107.

145. Rose & Sharfman, *supra* note 1, at 1015.

between the controlling shareholder and the Board,[146] and the Courts will not disturb that unity as long as the Board and the controlling shareholder do not act in breach of their fiduciary duties to the minority shareholders, if such shareholders exist.[147]

However, corporate law does not provide a clear path for shareholder activists who want to correct managerial inefficiencies. For example:

> While there is nothing stopping activists from engaging the Board either publicly or privately to advocate for a change in corporate strategies, corporate law provides little support for their recommendations outside of allowing them the opportunity to threaten or enter into a proxy contest, file either a direct or derivative lawsuit for a breach of a Board's fiduciary duties, proposing and voting on binding bylaw proposals, which may include the nomination of directors through proxy access, or proposing and voting on non-binding proposals if the Board cannot exclude them from the company proxy statement under SEC rules.[148]

Of course, the key difference between the acquirer and the shareholder activist is that the activist seeking to influence Board decision making does not have voting control and therefore does not have control of who gets to sit on the Board.[149] In the absence of a

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146. Copperweld v. Independence Tube, 467 U.S. 752, 753 (1984) ("A parent and its wholly owned subsidiary have a complete unity of interest. Their objectives are common, not disparate, and their general corporate objectives are guided or determined not by two separate corporate consciousnesses, but one. With or without a formal 'agreement,' the subsidiary acts for the parent's benefit.").

147. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (stating that "A parent does indeed owe a fiduciary duty to its subsidiary when there are parent-subsidiary dealings. However, this alone will not evoke the intrinsic fairness standard. This standard will be applied only when the fiduciary duty is accompanied by self-dealing—the situation when a parent is on both sides of a transaction with its subsidiary. Self-dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary."). *See generally* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1115–17 (Del. 1994) (holding that a self-dealing transaction between the controlling shareholder and the company will be reviewed under an entire fairness standard of review).

148. Rose & Sharfman, *supra* note 1, at 1028 (citing DEL. CODE ANN. tit. 8 § 109 (2011)); *see also* 17 C.F.R. § 240.14a-8(i); Blair & Stout, *supra* note 55, at 258. A non-binding shareholder proposal was a tool used by Relational in its engagement with Timken. *See, supra* note 91 and accompanying text.

149. Bainbridge, *Board as Nexus*, *supra* note 111, at 4.

controlling shareholder, something quite extraordinary happens to how corporate law approaches corporate governance. A "property rights" approach to corporate governance is abandoned, as there is no longer a presumed unity of interest between shareholders and the Board.[150] That is, there is no one shareholder or shareholder group that can be viewed as having indirect control of the corporation's assets[151] through its control of the Board. Instead, corporate law takes a nexus of contracts, or "contractarian," approach to the corporation.[152] Shareholders are no longer perceived to own the corporation but are considered to be just one of many parties that contract with the corporation.[153] The diffusion of shareholder ownership means that the board of directors is firmly in control of corporate decision making,[154] as described in Part IV.

A. The Issue

How then should the courts treat Board actions when they directly or indirectly have the effect of squelching offensive shareholder activism? That is the issue that corporate law must resolve. The issue pits corporate law's presumption of Board superiority in decision making against empirical studies that find offensive shareholder activism wealth enhancing and a corrective mechanism in corporate governance.[155] What is at stake is the ability of the offensive shareholder activist, usually an activist hedge fund, to function at a significant level of influence in corporate decision making if corporate law allows the Board free reign to squelch such activism.

B. A Proposed Approach for Corporate Law

As already discussed, corporate law takes what Michael Dooley calls an "Authority Model,"[156] and what Stephen Bainbridge calls a "Director Primacy,"[157] approach to corporate governance. Under this approach, the burden on the plaintiff is extremely high.[158] However,

150. Blair & Stout, *supra* note 55, at 255 (describing how one party sometimes obtains all contractual rights).

151. *See id.* at 260–61.

152. Bainbridge, *Board as Nexus*, *supra* note 111, at 6.

153. Bainbridge, *Director Primacy*, *supra* note 111, at 547–48.

154. *See* DEL. CODE ANN. tit. 8 § 141(a) (2015).

155. Rose & Sharfman, *supra* note 1, at 1043.

156. Dooley, *supra* note 110, at 463.

157. Bainbridge, *Director Primacy*, *supra* note 111; Bainbridge, *Board as Nexus*, *supra* note 111, at 6.

158. Dooley, *supra* note 110, at 477.

since all Board decisions are subject to fiduciary duties, there is always the possibility that Board actions taken to squelch offensive shareholder activism may be a breach of the directors' duties of care and loyalty.

Unfortunately, empirical studies demonstrating the benefits of offensive shareholder activism also make it difficult for corporate law to apply any type of approach in a *precise* manner. As already noted, while it is clear that offensive shareholder activism significantly enhances shareholder wealth in general, the wealth enhancement has been primarily a result of recommendations that have led to "the sale of the company or changes in business strategy, such as refocusing and spinning-off noncore assets."[159] Moreover, these empirical studies are based on a large sample size of historical activist engagements and therefore do not provide any guidance to the Court on which party, the Board of the offensive shareholder activist, is actually correct in the fact pattern currently under review.[160]

However, the limitations inherent in these empirical studies do not mean that corporate law now has liberty to completely ignore offensive shareholder activism. On the contrary, to make sure corporate law does not deny shareholders the benefits of such activism in correcting managerial inefficiencies and thereby conflict with its objective of facilitiating the default corporate objective of shareholder wealth maximization,[161] corporate law should always take a skeptical view of any Board action taken to directly or indirectly mitigate the influence of this type of activism. By being overinclusive and not underinclusive in terms of offensive shareholder activism, corporate law can help ensure that the general result of offensive shareholder activism being wealth enhancing for shareholders is incorporated into corporate governance. How the courts can implement such an approach is demonstrated below by using the facts and legal analysis found in the recent case of *Third Point LLC v. Ruprecht*.[162]

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159. Brav et al., *Hedge Fund Activist, Corporate* Governance, *supra* note 5, at 1731; *see also* Greenwood & Schor, *supra* note 5, at 363 (finding that abnormal positive returns only existed when the activism was associated with the ultimate sale of the target to a third party). *See also*, Nicole M. Boyson, Nickolay Gantchev, and Anil Shivdasani, *Activism Mergers* (Oct. 21, 2015), *available at* http://ssrn.com/abstract=2677416. An example of a spin-off is found in Relational's recommendation that Timken Co. spin off its steel operations into a separate public company. *See* Rose & Sharfman, *supra* note 1, at 1036, and accompanying text.

160. Rose & Sharfman, *supra* note 1, at 1042.

161. *See* Jensen, *supra* note 41, at 17.

162. Third Point LLC v. Ruprecht, No. 9469-VCP, slip op. (Del. Ch. May 2, 2014).

C. *The Facts of* Third Point LLC v. Ruprecht

Third Point LLC ("Third Point"), a hedge fund/offensive shareholder activist, began accumulating stock in Sotheby's and ultimately held 9.6% of Sotheby's voting common stock.[163] Its first sizable purchase was announced on May 15, 2013.[164] Third Point was led by its CEO, Daniel Loeb,[165] a self-professed art lover.[166] Sotheby's was a high-end art auction house who, along with Christie's, dominated the high-end marketplace.[167] Sotheby's was a public company traded on the New York Stock Exchange.[168] Sotheby's had an unstaggered Board and therefore was vulnerable to a proxy contest initiated by a shareholder activist.[169] William F. Ruprecht was the CEO and Chairman of Sotheby's and the only employee on Sotheby's board of directors.[170] Trian Fund Management ("Trian") and Marcato Capital Management soon followed suit.[171] They ultimately ended up holding 3.00%[172] and 6.61%[173] of Sotheby's voting common stock, respectively.

Most notably, the changes recommended by the activists did not include a sale of the company or a change in business strategy, the types of changes that the empirical studies have shown to significantly enhance shareholder value.[174] For example, Marcato wanted Sotheby's to distribute its cash on hand to its shareholders,[175] and Loeb wanted to remove the current CEO, Ruprecht,[176] and bring in a new management team that included himself.[177] The opinion did not state what Trian was looking for in the way of changes.

The amount of Sotheby voting common stock Third Point owned increased at a good pace over the time of its activism. On August 14, 2013, it was reported to be 3.6%;[178] on August 26, 2013, it was

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163. *Id.* at 3.
164. *Id.* at 6.
165. *Id.* at 3.
166. *Id.* at 8.
167. *Id.* at 3, 5.
168. *Id.* at 3.
169. *Id.* at 6.
170. *Id.* at 3.
171. *Id.* at 7.
172. *Id.* at 13.
173. *Id.* at 7. Morgan Stanley also acquired a passive 5.1% stake in Sotheby's. *Id.*
174. Rose & Sharfman, *supra* note 1, at 1042–43.
175. *Third Point LLC*, slip op. at 11.
176. *Id.* at 20.
177. *Id.* at 19.
178. *Id.* at 13.

5.7%;[179] on October 2, 2013, it was 9.4%;[180] and on March 13, 2014, it was 9.6%.[181]

On October 4, 2013, just after it was disclosed that Third Point's stake in Sotheby's had increased to 9.4%, Sotheby's board of directors adopted a Shareholder Rights Plan poison pill.[182] However, this was no ordinary poison pill. It included an unusual two-tier structure regarding the level of ownership required to trigger the plan.[183] The trigger level would be anything greater than 20% ownership of the company's voting common stock if it involved a passive investor as identified by an SEC Form 13G filing.[184] But the trigger level would only be anything greater than 10% if it involved an offensive shareholder activist as identified by a Form 13D filing.[185]

On February 27, 2014, Third Point amended its Schedule 13D to announce that it was initiating a proxy contest to elect a slate of *three* directors to be voted on at the next annual meeting.[186] On March 13, 2014, Third Point requested that Sotheby's waive the 10% trigger and allow it to purchase up to a 20% stake in the company.[187] On March 19, 2014, the Board denied the waiver, knowing that the proxy contest was most likely a dead heat and that the waiver would most likely allow Third Point to win its proxy contest.[188]

On March 25, 2014, in response to the waiver denial, Third Point filed suit seeking a preliminary injunction to enjoin Sotheby's annual meeting.[189] The delay's purpose was to give the chancery court time to hold a trial to review the legality of the discriminatory poison pill and the refusal of the Board to provide Third Point with a waiver from its restrictions.[190]

D. The Legal Issues

In determining whether the injunction should be granted, the vice chancellor needed to determine the reasonable probability of

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179. *Id.* at 14.
180. *Id.* at 19.
181. *Id.* at 28.
182. *Id.* at 21.
183. *Id.* at 22.
184. *Id.*
185. *Id.* at 23.
186. *Id.* at 27.
187. *Id.* at 28.
188. *Id.* at 29–31.
189. *Id.*
190. *Id.*

success of the plaintiff's claims based on the merits.[191] This involved a review of two Board decisions. First, whether the Board breached its fiduciary duties when it adopting the discriminatory poison pill.[192] Second, whether the Board breached its fiduciary duties when it denied Third Point the waiver from the poison pill's 10% trigger.[193]

1. Decision # 1: Adopting the "Poison Pill"

The court begins its review by choosing the *Unocal* test[194] as its standard of review. The court felt compelled to do so because the *Unocal* test has been Delaware's exclusive standard of review for poison pills since the landmark case of *Moran v. Household International, Inc.*[195] Moreover, "a reviewing court must apply the *Unocal* standard of review whenever a board of directors adopts any defensive measure 'in response to some threat to corporate policy and effectiveness which touches upon issues of control.'"[196] As discussed below, the *Third Point* facts are consistent with this review requirement.

The *Unocal* test consists of two prongs.[197] The first prong requires the Board to demonstrate "reasonable grounds for believing that a danger to corporate policy and effectiveness existed."[198] That is, "a board must articulate a legally cognizable threat."[199] "Directors satisfy [this prong] by demonstrating good faith and reasonable investigation."[200] Evidence of "good faith and reasonable investigation" is "materially enhanced . . . by the approval of a board comprised of a majority of outside independent directors."[201]

191. *Id.* at 34 ("To obtain a preliminary injunction a plaintiff must demonstrate: (1) a reasonable probability of success on the merits; (2) that absent injunctive relief, they will suffer irreparable harm; and (3) that the balance of the parties' harms weighs in favor of injunctive relief. An injunction will not issue unless all three elements are satisfied.").

192. *Id.*

193. *Id.*

194. *Id.* (citing Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949 (Del. 1985).

195. *Id.* (citing *Unocal*, 493 A.2d at 949).

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

197. *Third Point LLC*, slip op. at 37.

198. *Id.* (quoting *Unocal*, 493 A.2d at 955).

199. *Id.*

200. *Id.* (quoting Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1152 (1990) (citation omitted)).

201. *Unocal*, 493 A.2d at 955 (citing Cheff v. Mathes, 199 A.2d 548, 555 (Del. 1964)).

However, prior to applying *Unocal's* second prong, the *Blasius* standard of review must be included in the review of defensive measures when a contested election (proxy contest) is affected by the Board actions:

> When the *primary purpose* of a board of directors' defensive measure is to interfere with or impede the effective exercise of the shareholder franchise in a contested election for directors, the board must first demonstrate a compelling justification for such action as a condition precedent to any judicial consideration of reasonableness and proportionately.[202]

If the *Blasius* standard does not apply or has been satisfied, then the second prong, "a proportionality test, [must be] satisfied by a demonstration that the . . . defensive measure [Sotheby's poison pill] was reasonable in relation to the threat posed."[203] The review for proportionality is another two-part test.[204] First, the court must determine whether the defensive measure was "draconian, by being either preclusive or coercive."[205] Second, "if the Board's response to the threat was [determined] not [to be] draconian, the Court must then decide [if the defensive measure] fell 'within a range of'" reason.[206] Under *Unocal*, the burden of proof is on the board of directors.[207]

a. *The First Prong*

The Plaintiffs did not complain that the Board lacked "good faith [or] reasonable investigation."[208] Nevertheless, the court noted that "[t]he presence of a majority of outside directors, coupled with a showing of reliance on advice by legal and financial advisors, 'constitute[s] a *prima facie* showing of good faith and reasonable investigation.'"[209] Thus, even though not raised as an issue in this case because it was not supported by the facts, plaintiffs in other cases involving offensive shareholder activism may have a possible

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202. MM Cos. v. Liquid Auto, Inc., 813 A.2d 1118, 1132 (citing Stroud v. Grace, 606 A.2d 75, 92 n.3 (Del. 1992)).

203. *Third Point LLC*, slip op. at 38 (quoting *Unocal*, 493 A.2d at 955).

204. *Id.* at 34.

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

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

207. *Id.* at 38.

208. *Id.* at 39.

209. *Id.* (citation omitted).

claim that the Board lacked good faith and reasonable investigation under the *Unocal* test if the facts show that the Board did not consider the recommendations made by the offensive shareholder activist.[210] This would be consistent with the Delaware Supreme Court's opinion in *Lyondell v. Ryan* where it prescribed the standard for when a Board's lack of good faith would rise to the level of a breach of loyalty: "[o]nly if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty."[211]

In regard to the "cognizable threat," the Court accepted that the Board was concerned about "creeping control."[212] That is, the aggregate position held by the activist hedge funds in the company's common stock could potentially allow them to gain control "without paying a control premium."[213] Moreover, the Court accepted that it was reasonable for the Board to fear that the activist funds were forming a "wolf pack"[214] for such a purpose.[215]

Given how deferential the *Unocal* test is to defensive measures instituted by the Board, this was not an unexpected result.[216] The Court then turned to see if the *Blasius* standard applied.[217]

b. *Applying* Blasius *within the* Unocal *test*

The court emphatically concluded that Sotheby's Board did not implement the poison pill with "the *primary purpose* of interfering with the [proxy contest that Third Point was to launch] several

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210. *Id.* at 39.

211. Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 237 (Del. 2009).

212. *Third Point LLC*, slip op. at 49.

213. *Id.* at 40.

214. *Id.* A wolf pack is made up of a "loose network of activist investors" able to "take collective (or, at least, parallel) action without forming a 'group' for purposes of the federal securities laws (which would trigger an earlier disclosure obligation)." *See* Coffee & Palia, *supra* note 97, at 3, 23. According to Brav, Dasguptaz & Mathews, a wolf pack is made up of a lead hedge fund and multiple peripheral activists. *See* Alon Brav et al, *Wolf Pack Activism* 3, 4 (Robert H. Smith Sch., Research Paper No. RHS 2529230 (2015)). They found that "[h]olding constant total activist ownership, the presence of a lead activist increases the probability of successful activism due to improved coordination among activists." *Id.* at 1.

215. *Third Point LLC*, slip op. at 40.

216. Mary Siegel, *The Illusion of Enhanced Review of Board Actions*, 15 U. PA. J. BUS. L. 599, 619–21 (observing that overall, defendants under *Unocal* have been successful 79% of the time overall, and 84% of the time when an independent board is present).

217. *Third Point LLC*, slip op. at 41.

months later."[218] That is, at the time of implementation, there was no interference with Third Point's shareholder franchise.[219] According to the court, the facts demonstrate that the poison pill was implemented to ward off "certain hedge funds [from] attempting to gain effective control of [Sotheby] without paying a premium."[220] Moreover, the court listed a number of other reasons why the poison pill was not implemented with the primary purpose of interfering with the shareholder franchise.[221] First, there was no evidence that the Board was acting for purposes of entrenchment.[222] Second, the majority of the Board did not implement the poison pill because of its dislike for Loeb's actions.[223] Third, the apparent effect of the poison pill was not coercive or preclusive, a finding that also meets the requirement under *Unocal*'s second prong that the defensive measure not be draconian.[224] According to the court, it "does not contain any features that would outright force a stockholder to vote in favor of the Board or allow the Board to induce votes in its favor through more subtle means."[225] Neither was it preclusive.[226] According to the court, "It is undisputed that Third Point's proxy contest with the Board is eminently winnable by either side. Therefore, even with a 10% cap on the number of shares it can acquire, there is no credible argument that Third Point's success in the pending proxy contest is "realistically unattainable."[227]

However, what was missing from the Court's analysis was the inclusion of the factor that the influence of an offensive shareholder activist in the corporate governance of the company was being negatively affected by the poison pill. Being able to hold an additional 10% of Sotheby's voting common would have significantly helped Third Point move the sitting Board in the direction it wanted to take the company.[228] The inclusion of this factor in the court's analysis would have provided at least one factor in favor of demonstrating that the Board was trying to interfere with Third Point's shareholder franchise. Nevertheless, given that this factor

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218. *Id.*

219. *Id.*

220. *Id.*

221. *Id.*

222. *Id.* at 43.

223. *Id.* at 42–43.

224. *Id.* at 38; Unocal v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985); *see* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1367 (Del. 1995).

225. *Third Point LLC*, slip op. at 44.

226. *Id.*

227. *Id.* at 44–45 (quoting Versata Enters., Inc. v. Selectica, Inc., 5 A.3d 586, 601 (Del. 2010)) (internal quotations omitted).

228. *Id.* at 47.

stands alone against the other factors just mentioned, it probably would not have been enough to convince the Court that the *Blasius* standard applies.

c. *The Proportionality Test under* Unocal

Under the proportionality test, the court looked to see if the Board's response to the specific threat, the acquisition of control by Third Point and the other hedge fund activists without paying a premium, was reasonable.[229] Indeed, the court found the discriminatory rights plan to be so.[230] It first noted that "[b]ecause the entire Board, collectively, owns less than 1% of Sotheby's stock, a 10% threshold allows activist investors to achieve a substantial ownership position in the Company."[231] It also noted, apparently consistent with the wolf pack theory, that "[a] trigger level much higher than 10% could make it easier for a relatively small group of activist investors to achieve control, without paying a premium, through conscious parallelism."[232]

Finally, the court addressed the most striking feature of the poison pill: its two-tier structure where passive investors are allowed to own up to 20% of the company, but activist investors are only allowed to own 10%.[233] First, it noted that the discriminatory poison pill "is a 'closer fit' to addressing the Company's needs to prevent an activist or activists from gaining control than a 'garden variety' rights plan that would restrict the ownership levels for every stockholder, even those with no interest in obtaining control or asserting influence."[234] What the court is trying to say is that the discriminatory poison pill helps minimize the reduction in potential demand for the company's stock by allowing for demand by passive investors at a level above 10%. If the poison pill was set at 10% and was non-discriminatory, it would not allow for this type of investment.[235] In any event, this is consistent with the Delaware Supreme Court's acknowledgment and acceptance since *Unocal* that defensive measures can be unfair to hostile bidders seeking control.[236] Moreover, since *Moran*, it has been acceptable that poison

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229. *Id.* at 45–46 (citations omitted).

230. *Id.* at 46.

231. *Id.* at 46–47.

232. *Id.* at 47 (citation omitted).

233. *Id.*

234. *Id.* at 47–48.

235. *Id.*

236. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 957 (focusing on the acceptability of a discriminatory self-tender offer).

pills be discriminatory in terms of making it difficult, but not impossible, for a hostile bidder to gain control through a proxy contest.[237] Thus it is the level of the trigger, not the discriminatory nature of the trigger, an attribute which it has always possessed, that is important.

Second, since the court already found that a 10% cap was reasonable for activist investors, the issue became whether it was unreasonable under the proportionality test to cap passive investors at 20%.[238] The court found this to be a non-issue because under the facts of the case, there were no passive investors with holdings even close to the lower 10% limit for activist shareholders.[239]

In sum, the decision to implement the poison pill was acceptable under both *Unocal* and *Blasius*.

2. Decision # 2: Rejection of the Waiver

The second decision that came under a *Unocal* review was the Board's decision to deny Third Point a waiver so it could accumulate up to 20% of Sotheby's voting common stock.[240] Here, the incorporation of offensive shareholder activism into the analysis is much more interesting.

a. The First Prong

It is important to note that this decision occurred five months after the rights plan was implemented and that the court was skeptical that the Board still had an "objectively reasonable belief that [there was still the threat] of 'creeping control.'"[241] Instead, the court found that the "objectively reasonable and legally cognizable threat" under the first prong had become "negative control."[242] According to the Court,

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

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237. Moran v. Household Int'l, Inc., 500 A.2d 1346, 1355 (Del. 1985).
238. *Third Point LLC*, slip op. at 48.
239. *Id.* at 48–49.
240. *Id.* at 50.
241. *Id.*
242. *Id.*

Moreover,

> If Third Point . . . achieved 20% ownership . . . . that fact, combined with the aggressive and domineering manner in which the evidence suggests Loeb has conducted himself in relation to Sotheby's, provides an adequate basis for legitimate concern that Third Point would be able to exercise influence sufficient to control certain important corporate actions, such as executive recruitment, despite a lack of actual control or an explicit veto power.[243]

This Article's theory of shareholder activism conflicts strongly with the Court's application of negative control under the *Unocal* test. Taking advantage of what the Court calls "negative control" is precisely how offensive shareholder activism benefits the corporate governance of the firm. The offensive shareholder activist tries to exert as much influence as possible on the Board under the constraint of not having actual control. It exists in the market of corporate influence, not control. The application of negative control under *Unocal* would be a powerful and blunt tool in mitigating the influence of offensive shareholder activism and the wealth benefits it provides to all shareholders.

Even the court acknowledged that significant problems exist with applying negative control under *Unocal*: "The notion of effective, rather than explicit, negative control obviously raises some significant concerns, chief among them being where does one draw the line to ensure that 'effective negative control' does not become a license for corporations to deploy defensive measures unreasonably."[244] Moreover, the Board was overwhelmingly independent; the only Sotheby employee on the Board was Ruprecht.[245] In addition, Third Point sought minority representation on the Board, not majority representation.[246] Therefore, it is not totally clear how "negative control" would be implemented. In sum, the application of negative control under this fact pattern should not establish an "objectively reasonable and legally cognizable threat" under the *Unocal* test.[247]

b. Applying Blasius *within the* Unocal *test*

The Court's determination under *Blasius* was a close call:

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243. *Id.* at 51–52.
244. *Id.* at 50.
245. *Id.* at 3.
246. *Id.* at 19.
247. *Id.* at 50.

> I do not find that the Board refused to provide the waiver for the primary purpose of interfering with the franchise of Third Point. Based on the record before me, however, that question is uncomfortably close. It gives me pause that the Board elected not to grant Third Point the waiver it sought soon after the Board learned from its proxy advisors that allowing Third Point to acquire an additional 10% stake likely would ensure a Third Point victory in the ongoing proxy contest. I am not unsympathetic to Plaintiffs' position here. . . . Plaintiffs' claims that the challenged actions of the Board improperly impinge on the shareholders franchise appear to be at least colorable and raise important policy concerns that deserve careful consideration in the examination of poison pills under *Unocal*.[248]

Again, what was missing from the court's analysis was including the factor that the influence of an offensive shareholder activist in the corporate governance of the company was being negatively affected by the Board's actions. This time, the Board action was the denial of the waiver.[249] Again, being able to hold an additional 10% of Sotheby's voting common would have significantly helped Third Point move the sitting Board in the direction it wanted to take the company. The inclusion of this significant factor in the court's analysis would arguably have moved the court to find that the denial was primarily to interfere with the shareholder franchise.

c. The Second Prong

Since the rights plan was neither preclusive nor coercive, the decision to deny the waiver could not be preclusive or coercive.[250] This left the court only to review the decision under the proportionality test.[251] The court found that the Board's refusal to grant the waiver was a reasonable response to the threat posed by negative control to corporate policy and effectiveness and was therefore not a breach of the Board's fiduciary duties.[252]

In sum, the incorporation of offensive shareholder activism as a factor in the court's analysis of the waiver denial would arguably have changed the analysis in terms of both the first prong of the *Unocal* test and the *Blasius* review. Such an inclusion in the analysis would have helped the court to understand that negative

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248. *Id.* at 52, n.39.
249. *Id.* at 34.
250. *Id.* at 53.
251. *Id.*
252. *Id.*

control was not an "objectively reasonable and legally cognizable threat" under the first prong of the *Unocal* test and that the *Blasius* standard should have been applied. If so, then Plaintiff's request for preliminary injunctive relief should have been granted at least based on the merits.

VI. CONCLUSION

Corporate law's recognition of offensive shareholder activism as a corrective mechanism begins with the adoption of Manne's premise that there exists "a high positive correlation between corporate managerial efficiency and the market price of shares of that company."[253] Adopting this premise allows for an argument to be made in the context of shareholder activism that closely parallels Manne's argument defining the market for corporate control: In the context of public companies, shareholder activism may constitute a valuable asset in and of itself if the goal of such activism is to enhance managerial efficiency.

The challenge for corporate law is to find room for offensive shareholder activism in a legal structure of statutory default rules and common law decisions that have long been dominated by the perspective that the board of directors is the locus of authority for making the most efficient corporate decisions. To meet this challenge, corporate law must begin to create a body of law that incorporates the view that offensive shareholder activism acts as a corrective mechanism in corporate governance and therefore justifies a skeptical outlook on any Board action that is taken to directly or indirectly mitigate the influence of such activism.

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253. Manne, *Mergers & the Market*, *supra* note 8, at 112.