

AGAINST ALL ODDS: HEDGE FUND ACTIVISM IN CONTROLLED COMPANIES

Kobi Kastiel*

The importance of shareholder activism in widely held public companies is already broadly recognized. Less well understood, however, is the role that activist hedge funds play in public companies with a controlling shareholder, and the common view has been that dispersed stock ownership is typically a precondition for activist intervention. To fill this gap, this Article presents the first comprehensive account of hedge fund activism in controlled companies in the United States. Using empirical data and illustrative examples from recent years, the Article finds a surprising number of activist engagements with controlled companies, and unveils the variety of channels through which activism is deployed as well as the limitations of these channels. It concludes by offering regulators and institutional investors some suggestions for further empowering activists in controlled companies, such as granting investors unaffiliated with the controllers the right to elect minority directors.

* Fellow of the Program on Corporate Governance and Terence M. Considine fellow at the Center for Law, Economics and Business, Harvard Law School. I am grateful to Lucian Bebchuk and Jesse Fried for their valuable guidance and advice. I would also like to thank Jonathan Arbel, Arevik Avedian, John Coates, Assaf Hamdani, Scott Hirst, Yotam Kaplan, Louis Kaplow, Thomas Keusch, Reinier Kraakman, Yaron Nili, Edward Rock, Mark Roe, Roy Shapira, Steven Shavell, Holger Spamann, Richard Squire, the participants in the Law and Economics Seminar at Harvard Law School, the 25th Annual Meeting of the American Law and Economics Association, the Corporate Governance Fellows Group at Harvard Law School, and the faculty workshops at Bar Ilan University, Hebrew University, Interdisciplinary Center Herzliya, and Tel Aviv University for helpful conversations, comments and suggestions. Generous financial support was provided by the Law School's John M. Olin Center, the Program on Corporate Governance, and the Harvard Law School Summer Academic Fellowship Program.

I. Introduction	61
II. Hedge Fund Activism in Controlled Companies:	
Background.....	70
A. The Stakes.....	70
B. The Initial Hypothesis.....	74
C. Prior Empirical Research.....	76
III. Hedge Fund Activism and Ownership Structure	80
A. Data Collection	80
B. Results and Analysis	82
1. Activism and Ownership Structure.....	82
2. Different Type of Activism?	85
IV. The Formal Channels of Activism	88
A. The Right to Nominate and Elect Minority Directors.....	90
1. Dual-class Firms.....	90
2. Effectively-controlled Firms.....	95
B. Minority’s Veto Power in Going-private Transactions.....	99
C. Activism in the Shadow of Litigation	102
V. The Informal Channels of Activism.....	104
A. Unbundling Controllers’ Reputational Concerns.....	104
B. The Role of Reputation in Encouraging Activism.....	107
1. Activism Against All Odds.....	107
2. The Reliance of Reputation on the Formal Channels	112
VI. Disruptive Activism?	116
VII. Policy Implications.....	125
VIII. Conclusion	130

I. INTRODUCTION

In early 2008, the activist hedge funds Harbinger Capital Partners and Firebrand Partners sent a public letter to The New York Times Company. The activists, who together held 4.9% of the company’s Class A shares, expressed the view that the company’s board had been ineffective in delivering value. They called for a renewed focus on the company’s core

assets and the redeployment of capital to expedite the company's presence in digital media.¹ The activists also criticized the Times Company's empire building,² and pressed the company to sell some of its non-core assets,³ such as its stakes in the Boston Red Sox,⁴ Roush Fenway Racing (a leading NASCAR race team),⁵ and *The Boston Globe* newspaper, which fared worse than many other metropolitan dailies in years that preceded the engagement.⁶ "There is nothing wrong with the New York Times Company that cannot be fixed with what is right with *The New York Times*,"⁷ the activists summarized.

The timing of the activist engagement was not surprising. It started when the company's share price had fallen to an eleven-year low,⁸ and after a long-term major shareholder, Morgan Stanley Investment Management, led a vocal two-year campaign criticizing the Times Company's business performance and corporate governance practices.⁹ During the

¹ Exhibit to The New York Times Co., Proxy Statement (Form 14A) 7 (Jan. 1, 2008).

² In addition to its flagship newspaper, the Times Company owned thirty-one regional newspapers, twenty magazines, five television stations, two radio stations, and other businesses. It also had a half-interest, with the Washington Post Company, in *The International Herald Tribune*, the Boston Red Sox, and a NASCAR race team. *See infra* note 14.

³ *See supra* note 1.

⁴ The New York Times Co., Annual Report (Form 10-K) 1 (Feb. 22, 2011).

⁵ *Id.*

⁶ *See* Russell Adams, *New York Times May Cut Payout*, WALL. ST. J. (Oct. 24, 2008), <http://www.wsj.com/articles/SB122478493122263159?cb=logged0.7962122080435743> [<https://perma.cc/MTR7-97VR>] (noting that in 2006, the *Times*, which paid \$1.1 billion for the *Globe* in 1993 (among the highest prices paid for an American newspaper), took an \$814 million write-down on its New England assets).

⁷ *See supra* note 1.

⁸ Joshua Chaffin, *Hedge Fund Lashes Out at NYT Board*, FIN. TIMES, (Jan. 28, 2008), <http://www.ft.com/intl/cms/s/0/5eae7fba-cd3a-11dc-9b2b-000077b07658.html#axzz42LvTOajM> [<https://perma.cc/TB9C-F3CJ>].

⁹ *See, e.g.*, Merissa Marr, *New York Times Co. Relents on Board Seats*, WALL. ST. J. (Mar. 18, 2008), <http://www.wsj.com/articles/SB120577291969142019> [<https://perma.cc/7ZQR-QU6J>] (reporting this campaign).

course of its campaign, Morgan Stanley argued that according to independent analysts the Times Company's shares were worth 50% more than its stock price at the time, that they were deeply underpriced because of improper management, and that despite such significant underperformance, management's total compensation had increased considerably over this period.¹⁰ Indeed, at the company's 2007 annual meeting, public investors holding 42% of the Times Company's Class A shares withheld their votes for directors in protest.¹¹

The activists' pressures were not fruitless. In March 2008, Harbinger and Firebrand reached a settlement agreement with the Times Company pursuant to which the company agreed to increase the size of the board from thirteen to fifteen members and to appoint the activists' nominees to the board.¹² Additionally, in the years following the engagement, the company started to implement investors' demands for changes to the business. It reduced capital spending, lowered its operating costs,¹³ and divested itself of underperforming assets such as *The Boston Globe*.¹⁴

¹⁰ Morgan Stanley Investment Management (Schedule 13D) 5 (Apr. 18, 2006).

¹¹ *Supra* note 9. Excluding stock held by the controlling family, this figure represented a majority of shareholders unaffiliated with the controller.

¹² *See* The New York Times Co., Proxy Statement (Form 14A) (Mar. 17, 2008).

¹³ *See supra* note 6 (noting that Times Company executives said the company would exceed its cost-cutting target of \$230 million by 2009 and that it would look for more opportunities to reduce debt). *See also* Joshua Chaffin, *New Voices to Join Call for Change at NY Times*, FIN. TIMES (Apr. 22, 2008), <http://www.ft.com/intl/cms/s/0/ff731a6e-0fc5-11dd-8871-0000779fd2ac.html#axzz42LvTOajM> [<https://perma.cc/4GEM-LF88>] (describing the company's cut in the newsroom staff).

¹⁴ Christine Haughney, *New York Times Company Sells Boston Globe*, N.Y. TIMES (Aug. 4, 2013), http://www.nytimes.com/2013/08/04/business/media/new-york-times-company-sells-boston-globe.html?_r=0 [<https://perma.cc/2YDG-K8SR>]. Additionally, starting in 2009 the Times Company pursued a sale of its stakes in radio stations and regional news groups. By 2012, the company sold its sixteen regional newspapers, as well as the "About" Group and its stake in the Red Sox. *See* Greg Bensinger, *New*

At first glance, this intervention looks no different than many other engagements with large U.S. companies conducted by activist hedge funds, which accumulate large but non-controlling stakes in target companies to bring about change in the companies' strategic, operational, or financial activity, often while threatening to nominate their representatives to the board.¹⁵ In the last decade, hedge funds have become critical players in the corporate governance arena,¹⁶ and hundreds of activist campaigns have resulted in board seats.¹⁷ But the engagement with The New York Times Company is far from typical. The New York Times Company is a company with concentrated ownership; since the purchase of the newspaper by Adolph S. Ochs in 1896, control of the company has rested with his family.¹⁸

York Times to Get \$45 Million for Radio Station, BLOOMBERG NEWS (July 14, 2009), <http://www.bloomberg.com/news/articles/2009-07-14/new-york-times-to-get-45-million-for-radio-station> [<https://perma.cc/TUT9-P8B7>]. See also Beth Healy, *New York Times Co. Sells Last of its Stake in Red Sox*, BOS. GLOBE (May 11, 2012), <https://www.bostonglobe.com/business/2012/05/11/new-york-times-sells-its-remaining-stake-boston-red-sox/ey4kwU4m6Xn2PYfclbrMcL/story.html> [<https://perma.cc/BK3X-FVJX>].

¹⁵ For a detailed definition of the main characters of hedge funds, see Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1734–36 (2008).

¹⁶ Up until a decade ago, the general view among corporate law scholars has been that public shareholders are generally passive and suffer from a collective action problem, and are therefore unable to effectively monitor management or controlling shareholders. See, e.g., WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS, 204–08 (3d ed. 2009). Institutional investors, who for a short period emerged as the new hope, also failed to deliver on their promise to provide more disciplined monitoring of management, as they suffer from inadequate incentives, conflicts of interest, and regulatory constraints. See, e.g., Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1048–57 (2007).

¹⁷ *Activists Increasing Success Gaining Board Seats at U.S. Companies*, SHARKREPELLENT.NET (Mar. 10, 2014), https://www.sharkrepellent.net/pub/rs_20140310.html [<https://perma.cc/XLL3-9TRD>].

¹⁸ See The New York Times Co., Proxy Statement (Form DEF 14A) 4–10 (Mar. 25, 2008).

Engagements with controlled companies should be rare, at least according to the conventional theory, since the presence of a controlling shareholder dramatically reduces the chances of a successful activist campaign.¹⁹ So what forces motivate activist hedge funds to engage with controlled companies? Could extra-legal forces—particularly the reputational concerns of controlling shareholders—serve as a substitute for activists’ ability to influence the voting rights of a controlled firm?

While an emerging body of legal and financial literature has examined the impact of activist hedge funds on the governance and value of the public firm,²⁰ little attention has been devoted to the role they play in controlled companies.²¹ Instead, the common view has simply held that hedge fund activism “is unlikely to be deployed where dispersed ownership is lacking.”²² To fill this gap, the Article presents

¹⁹ As discussed in Part II.B, the low chances of an activist campaign’s succeeding are due to lack of a proxy fight threat and activists’ limited ability to influence the voting results.

²⁰ See, e.g., *infra* notes 22, 36–40 (listing academic research on hedge fund activism).

²¹ The academic literature and Delaware case law use a broad definition of a controlled company to include a company with a dominant shareholder who exercises effective control over the corporate affairs by owning a significant fraction, but not necessarily the majority, of the company voting power. For a discussion, see *infra* note 84. In this Article, I define a controlled company as one where at least 30% of the voting rights are held by one dominant shareholder or a group of affiliated holders. It is a relatively high cutoff of insider ownership, aimed at confirming that an outside shareholder cannot easily contest such effective control.

²² See, e.g., Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 68–69 (2011) (noting that “influence-driven activism is unlikely to be deployed where dispersed ownership is lacking”); Dionysia Katelouzou, *Worldwide Hedge Fund Activism: Dimensions and Legal Determinants*, 17 U. PA. J. BUS. L. 789, 800 (2015) (noting that “the existence of controlling blocks in the candidate target company constitutes a ‘structural’ barrier to shareholder activism associated with activist hedge funds”) [hereinafter Katelouzou, *Worldwide Hedge Fund Activism*]; Tilman H. Drerup, *Long-Term Effects of Hedge Fund Activism in Germany* (2015) (unpublished manuscript) (on file with *The Columbia Business Law Review*) (noting that hedge funds avoid targets with strong incumbent shareholders).

the first comprehensive account of hedge fund activism in controlled U.S. companies. Based on a review of over 200 activist engagements targeting public companies with concentrated ownership from 2005 to 2014, it unveils the variety of channels through which activism is deployed against controlled companies, as well as their limitations.

A detailed analysis of the intensity of activism in controlled companies and of the channels that facilitate activist campaigns against those companies may have important implications beyond the descriptive and theoretical levels. First, such analysis is a crucial step before regulators decide whether to intervene in the marketplace, and what measures, if any, should be taken to increase activism in controlled companies. Second, this setting of activism against controlling shareholders also explores a new perspective on an interesting, long-standing issue in corporate governance—the potential role of reputation and extra-legal forces as alternative disciplinary mechanisms. A number of scholars have expressed the view that controlling shareholders might limit their efforts to divert firm resources to their pockets out of concern for their reputation,²³ but there is little empirical evidence examining the extent to which reputation markets replace, or at least supplement, legal mechanisms.²⁴ Since activists have a limited ability to influence firm decision-making when a target has a controlling shareholder, studying activist engagements with controlled companies is useful to examine whether reputation markets are effective enough in

²³ See *infra* note 149.

²⁴ Dyck and Zingales provide in their paper anecdotal examples of the potential disciplinary power of reputation. One of them was the successful activist engagement of Roberts Monks with Sears. Monks succeeded in initiating some major changes at the company after exposing to *The Wall Street Journal* the identity of Sears' directors and labeling them the "non-performing assets of the company." According to Dyck and Zingales, "[t]he embarrassment for the directors was so great that they implemented all the changes proposed by Monks." See Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 577 (2004).

compelling controllers to be more attentive to activists' demands.

A review of activists' engagements with controlled companies reveals a few important findings. First, it shows that although controlled companies are more insulated from activism than widely held companies, they are not fully immune to it. Somewhat counter-intuitively, this Article documents a non-negligible number of shareholder engagements with controlled firms,²⁵ and it shows that activists' bargaining power vis-à-vis controllers is not always as limited as initially predicted. It also shows that activism in controlled companies is not substantially different in nature from activism conducted in widely held companies. These engagements are often confidential, and in a large number of them activists also try to initiate strategic changes aimed to improve the way controllers manage their companies.²⁶ These unexpected findings trigger a question that stands at the heart of this Article: What mechanisms do activist hedge funds use when engaging with controlled companies?

This Article highlights a few motivating forces that increase activists' bargaining power vis-à-vis controllers and encourage activism, including the ability to nominate and elect minority directors in certain dual-class firms²⁷ or effectively-controlled firms,²⁸ to veto certain conflicted transactions (such as going-private transactions), and to conduct activism in the shadow of litigation.²⁹

²⁵ See *infra* Part III.A.

²⁶ See *infra* Part III.B.

²⁷ In a typical dual-class company, there is a publicly traded class of stock with inferior voting rights and an additional class of stock with superior voting rights, often not publicly traded. This latter class of stock is usually owned by the insiders of the firm and causes a significant wedge between the insiders' voting and cash-flow rights. See Paul A. Gompers, Joy Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051, 1052 (2010).

²⁸ Delaware law and corporate scholars recognize that a stockholder can achieve a controlling status with less than 50% of the voting power. For a discussion, see *infra* note 84 and Subpart IV.A.2.

²⁹ See *infra* Part IV.

Activists' ability to elect minority directors in certain dual-class firms (a mechanism that has received little attention from legal scholars) is of particular interest, as such a mechanism, which does not depend upon the existence of a conflicted transaction or a breach of fiduciary duty, generates a relatively high percentage of successful engagements with controlled companies. An examination of the origin of this mechanism shows that it was a product of an historical compromise between the American Stock Exchange ("AMEX") and issuers who wanted to take their companies public with a dual-class structure during a period when the use of dual-class stock was prohibited by the most important stock exchange at the time, the New York Stock Exchange ("NYSE"). However, current listing requirements of the major U.S. stock exchanges no longer impose any restrictions on new issuances of unequal voting stock, and controlled companies that went public in the past decade, when hedge fund activism gained steam, were less likely to voluntarily adopt such an arrangement and subject themselves to the disciplinary power of activist holders.³⁰

This raises another important question as to whether activist shareholders are willing to engage with controlled companies even when they lack any formal, legal rights that could facilitate those interactions. This Article uses the setting of "against all odds" engagements—engagements when the control is fully uncontested and the activists have no legal rights to challenge a controller—to explore whether the reputational concerns of controlling shareholders could serve as a substitute for the formal channels of activism, and make controllers attentive to activists' demands. Such examination shows that reputational concerns could play a role in disciplining controllers, but mostly when these forces serve as a *complementary* mechanism, operating in conjunction with other formal bargaining mechanisms that increase the public profile of an engagement, such as activists' ability to nominate a minority director and declare a proxy contest against the controller. When activists have

³⁰ See *infra* Part IV.A.

no apparent formal bargaining mechanisms, reputational markets alone have a mild disciplinary effect, at best, on controlling shareholders.³¹

Finally, despite the evidence showing that controlled companies are not fully insulated from activist interventions, this Article predicts that activists' ability to continue engaging with such companies could be severely limited in the future. A recent upward trend in the adoption of dual-class stock without any minority protections, such as board representation,³² is likely to better shield controllers from the disciplinary power of activists. The Article, therefore, calls upon regulators and institutional investors who view activism as an important disciplinary mechanism to not rely solely on the existing legal framework or on reputation markets to facilitate this activity. Instead, they are urged to adopt arrangements that will further encourage activism in controlled companies, and the most efficient way to accomplish this goal would be to grant shareholders unaffiliated with the controllers the right to elect minority directors.

Accordingly, this Article proceeds as follows. Part II lays out the stakes and then proceeds to introduce the initial hypothesis regarding the relationship between ownership structure and shareholder activism. As noted, this initial hypothesis suggests that hedge fund activism "is unlikely to be deployed where dispersed ownership is lacking."³³ Part III tests the validity of the initial hypothesis and presents data that is somewhat counter to it. Part IV presents the formal mechanisms that activist hedge funds use when engaging with controlled companies, and Part V supplements it by exploring the extent to which reputation markets discipline controllers. Part VI addresses concerns that activists' engagements with controlled companies could be harmful to other minority shareholders. It also shows that those

³¹ See *infra* Part V.

³² See *supra* notes 206, 212, and 224.

³³ See Cheffins & Armour, *supra* note 22. See also Katelouzou, *Worldwide Hedge Fund Activism*, *supra* note 22; Drerup, *supra* note 22.

concerns are not supported by general evidence or by the data presented in this Article. Finally, Part VII analyzes the various policy implications of the Article's findings.

II. HEDGE FUND ACTIVISM IN CONTROLLED COMPANIES: BACKGROUND

A. The Stakes

Many scholars consider the emergence of activist hedge funds as a major, ground-breaking shift in the corporate governance of public firms. Jonathan Macey, for instance, claimed that hedge funds “are the newest big thing in corporate governance”³⁴ and that they “actually deliver on their promise to provide more disciplined monitoring of management”³⁵ Frank Partnoy and Randall Thomas argued that “hedge funds recently have shaken up boardrooms and forced radical changes at many publicly-traded firms.”³⁶ And Ronald Gilson and Jeffrey Gordon see these activists as “governance entrepreneurs” who “arbitrage governance rights that become more valuable through their activity monitoring companies to identify strategic opportunities.”³⁷

Consistent with these claims, compelling empirical evidence supports the view that activist hedge funds can fill the monitoring gap created by “rationally apathetic” institutional shareholders by providing a closer check on management action. For instance, numerous studies on

³⁴ JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 241 (2008).

³⁵ *Id.*, at 272. See also Kahan & Rock, *supra* note 16, at 1047 (hoping that activist hedge funds “may act ‘like real owners’ and provide a check on management discretion”).

³⁶ Frank Partnoy & Randall Thomas, *Gap Filling, Hedge Funds, and Financial Innovation*, in NEW FINANCIAL INSTRUMENTS AND INSTITUTIONS: OPPORTUNITIES AND POLICY CHALLENGES 101 (Yasuyuki Fuchita & Robert E. Litan eds., 2007).

³⁷ 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, 897 (2013).

hedge fund activism find a correlation between interventions by activist hedge funds and positive stock market reactions following the engagement announcements.³⁸ Moreover, a recent study by Lucian Bebchuk, Alon Brav, and Wei Jiang shows that improved operating performance follows activist interventions not only in the short term, but also in the long term, during the five-year period following these interventions.³⁹ Finally, a recent survey of sixty-seven studies on shareholder activism concludes that hedge fund activism, which often involves the formation of ownership blocks, is associated with improvements in share values and firm operations, and has become more value increasing over time.⁴⁰

However, not everyone sees hedge fund activism as a positive development. Critics of hedge fund activism claim that hedge fund interventions are value-decreasing in the long term, and that activists tend to use their power to force management to disgorge cash in lieu of investing in long-term growth,⁴¹ though these criticisms are generally made with limited empirical evidence.⁴²

³⁸ See, e.g., April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN., 187, 207–11, 225–26 (2009); Brav et al., *Hedge Fund Activism*, *supra* note 15, at 1755–57; Christopher P. Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists*, 14 J. CORP. FIN. 323, 328–33 (2008). See also Robin Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON., 362–75 (2009) (finding that hedge funds specializing in forcing mismanaged target firms into mergers generate significantly positive returns).

³⁹ Lucian Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 114 COLUM. L. REV. (forthcoming 2015).

⁴⁰ Matthew Denes, Jonathan M. Karpoff & Victoria McWilliams, *Thirty Years of Shareholder Activism: A Survey of Empirical Research* (May 18, 2015) (unpublished manuscript), <http://ssrn.com/abstract=2608085> [<http://perma.cc/78WJ-YXL3>].

⁴¹ See, e.g., Ira M. Millstein, *Re-examining Board Priorities in an Era of Activism*, N.Y. TIMES: DEALBOOK (Mar. 8, 2013), <http://dealbook.nytimes.com/2013/03/08/re-examining-board-priorities-in-an-era-of-activism/> [<https://perma.cc/Y7GJ-XSAT>]; Wachtell, Lipton, Rosen & Katz, *Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 23, 2013),

Regardless of which side of the debate one supports, one thing is clear: activist hedge funds are important players in the corporate governance arena and are here to stay. The importance of activist funds is also reflected by the dramatic increase in their activity over the past fifteen years. Assets managed by activist hedge funds were worth \$23 billion in 2002,⁴³ grew to \$100 billion in 2006,⁴⁴ and to approximately \$200 billion by the beginning of 2015.⁴⁵ According to a recent report, the number of activist campaigns in 2014 reached 514, the highest since the 2008 financial crisis.⁴⁶

<http://corpgov.law.harvard.edu/2013/02/26/bite-the-apple-poison-the-apple-paralyze-the-company-wreck-the-economy/> [<https://perma.cc/XE7X-Q528>].

⁴² For studies invoked by critics of hedge fund activism, see Wachtell, Lipton, Rosen & Katz, *Is 2015, Like 1985, an Inflection Year?*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Dec. 8, 2015), <http://corpgov.law.harvard.edu/2015/12/08/is-2015-like-1985-an-inflection-year/> [<https://perma.cc/32L9-YB69>]. For a critical analysis of the evidence raised by hedge fund opponents, see Lucian Bebchuk, Alon Brav, Wei Jiang & Thomas Keusch, *The Long-term Effects of Hedge Fund Activism: A Reply to Cremers, Giambona, Sepe, and Wang*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Dec. 10, 2015), <http://corpgov.law.harvard.edu/2015/12/10/the-long-term-effects-of-hedge-fund-activism-a-reply-to-cremers-giambona-sepe-and-wang/> [<https://perma.cc/WM2T-QGCV>]; Lucian A. Bebchuk, *The Myth that Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1642–44 (2013).

⁴³ Cheffins & Armour, *supra* note 22, at 56–58 (discussing the move of hedge funds to the center stage).

⁴⁴ *Id.*

⁴⁵ See *Top Activist Hedge Funds Close in on \$200 Billion Mark; ValueAct Capital, Elliott Management & JANA Partners Lead the Way*, HEDGETRACKER.COM (Jan. 19, 2015), <http://www.hedgetracker.com/article/Top-Activist-Hedge-Funds-close-in-on-200-billion-mark-ValueAct-Capital-Elliott-Management-JANA-Partners-lead-the-way> [<http://perma.cc/6RFN-Y7JG>]. Even according to a more conservative estimation, the total assets under the management of activists funds, which was approximately \$50 billion in 2012, is still significant. See THECITYUK, FIN. MARKETS SERIES: HEDGE FUNDS 4 (May 2013).

⁴⁶ David A. Katz, *Engagement and Activism in the 2015 Proxy Season*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 6, 2015), <https://corpgov.law.harvard.edu/2015/02/06/engagement-and-activism-in-the-2015-proxy-season/> [<https://perma.cc/DZ94-GYN3>].

Surprisingly, although hedge fund activism has become such a significant phenomenon, scholars give little attention to the role, if any, that activists play in controlled companies. This topic warrants examination as a significant number of controlled companies exist even in the United States, where the model of widely held firms has long been dominant,⁴⁷ and the number of controlled companies keeps increasing due to a general upward trend in the adoption of dual-class stock structures.⁴⁸ Furthermore, activist hedge funds have recently entered the corporate governance arena of many European countries,⁴⁹ where concentrated ownership is the most prevalent type of ownership structure.⁵⁰ The international expansion of hedge fund activism makes the topic and

⁴⁷ See Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. 1377, 1382 (2009) (using a sample of 375 U.S. public corporations and finding that the average size of the largest block is 26%); Ronald Anderson, Augustine Duru & David M. Reeb, *Founders, Heirs, and Corporate Opacity in the U.S.*, 92 J. FIN. ECON. 205, 207 (2008) (showing that in the 2000 largest industrial U.S. firms, founder-controlled firms constitute 22.3% and heir-controlled firms comprise 25.3%, with average equity stakes of approximately 18% and 22%, respectively).

⁴⁸ This trend gained steam in 2004, when Google decided to go public with a dual-class structure, granting its co-founders almost two-thirds of company voting power. See, e.g., Jeff Green & Ari Levy, *Zuckerberg Grip Becomes New Normal in Silicon Valley*, BLOOMBERG (May 7, 2012), <http://www.bloomberg.com/news/articles/2012-05-07/zuckerberg-stock-grip-becomes-new-normal-in-silicon-valley-tech> [https://perma.cc/9MPQ-KN5R] (quoting Lise Buyer, principal at Class V Group in California: “When Google did it, there was tremendous pushback from the banks . . . Today the bankers are often the ones suggesting it. It may be everybody tries it, because the market seems to be giving everyone a pass.”).

⁴⁹ See, e.g., Dionysia Katelouzou, *Myths and Realities of Hedge Fund Activism: Some Empirical Evidence*, 7 VA. L. & BUS. REV. 460, 463–64 (2013) (showing that hedge funds in Europe and Asia have become more active in corporate governance decisions, and providing prominent examples) [hereinafter Katelouzou, *Myths and Realities of Hedge Fund Activism*]; see also sources in *infra* notes 60, 65–68.

⁵⁰ See, e.g., Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471, 491–97 (1999); Mara Faccio & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FIN. ECON. 365, 365 (2002).

findings of this Article important to policy makers both in the United States and in other countries.

B. The Initial Hypothesis

On its own, the presence of a controlling shareholder does not preclude other shareholders from acquiring a minority stake in a company. In theory, however, the existence of a controller should have a chilling effect on shareholder activism as a disciplinary mechanism, and should reduce activists' ex ante incentives to launch a campaign against a company. An activist player will choose to engage with a target if its expected benefits from an engagement outweigh its costs,⁵¹ which are related to identifying potential targets, financing an equity position, and communicating with the target.⁵² While the ownership structure of a target does not directly affect the costs of an activist campaign, the activist's expected return, which is a function of the size of its block and the expected increase in the target's stock price as a result of a successful intervention, likely decreases when the ownership percentage of the controller increases. This happens for two main reasons.

First, even if an activist shareholder attracts broad support from other passive investors,⁵³ the activist likely cannot bring credible proposals for change when a controlling shareholder, who often captures significant

⁵¹ For a comprehensive analysis as to when shareholder activism is a rational strategy, see Cheffins & Armour, *supra* note 22, at 61–68.

⁵² Gilson & Gordon, *supra* note 37, at 898 (discussing such costs). Nickolay Gantchev estimates that a public activist campaign that reaches the confrontational level of a proxy fight costs \$10.5 million, on average. Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*, 107 J. FIN. ECON. 610, 623 (2013). Engagement costs should be lower if an activist can prompt management to make changes with an initial letter, telephone call, or e-mail, and without initiating a fully-fledged proxy contest.

⁵³ Gilson & Gordon, *supra* note 37, at 897–98 (noting in the context of widely held firms that hedge fund intervention could succeed if the hedge fund manages to “attract broad support from institutional investors capable of assessing alternative strategies presented to them”).

private benefits from the status quo, controls a sufficiently large block of votes to deter or veto unwelcome shareholder initiatives.⁵⁴ Since activists' opportunity to generate profits from an undervalued company depends on the feasibility of bringing about change, the existence of a controller, who can block any proposal for change, should discourage activism.⁵⁵

Second, most activist campaigns operate in the shadow of a proxy fight for board representation. Although only a relatively small number of campaigns result in an actual proxy fight and activist hedge funds rarely seek to obtain full-scale voting control in their targets,⁵⁶ the mere threat of activists to nominate their representatives to the board encourages management of target companies to settle with the activists.⁵⁷ This threat of a proxy fight, however, lacks bite when a controlling shareholder exercises control over the firm's voting rights.

Since activist shareholders have limited resources for engagements, they prioritize targets. All else being equal,

⁵⁴ Initiating governance changes is a complicated task even in widely held firms (see, e.g., Sharon Hannes, *The Determinants and Consequences of Corporate Stagnation: Discussion and Reform Proposal*, 30 J. CORP. L. 51, 63–64 (2004)), and it becomes almost impossible when firms have a controlling shareholder.

⁵⁵ Cheffins & Armour, *supra* note 22, at 68–69. See also Katelouzou, *Worldwide Hedge Fund Activism*, *supra* note 22; Drerup, *supra* note 22.

⁵⁶ Brav et al., *Hedge Fund Activism*, *supra* note 15, at 1743 (reporting that in only 4% of their sampled activist interventions, the activist funds intended to take the target over, and in only 13% of the interventions, the activists launched a proxy contest); Gantchev, *supra* note 52, at 618–19 (showing that only 6.4% of the activist campaigns actually end up in a proxy contest); Katelouzou, *Myths and Realities of Hedge Fund Activism*, *supra* note 49, at 493 (showing that only 3.9% of the campaigns seek to launch a takeover bid).

⁵⁷ See, e.g., Partnoy & Thomas, *supra* note 36, at 136 (noting that “just the potential threat of hedge fund activism may stimulate corporate managers to engage in value maximizing change of control transactions before they become targets”); Katelouzou, *Myths and Realities of Hedge Fund Activism*, *supra* note 49, at 497 (noting that “[p]erhaps the most drastic strategy an activist hedge fund can employ in the course of an activist campaign is to threaten to launch—or actually launch—a takeover bid”).

the general hypothesis suggests that the presence of a controlling shareholder should make controlled companies less attractive targets for activists than widely held companies.⁵⁸ Or, as some scholars predict, “[d]ispersed stock ownership therefore is typically a necessary precondition for an influence-based intervention.”⁵⁹

C. Prior Empirical Research

Although there is a large body of literature on hedge fund activism, none of the research focuses specifically on activism in controlled U.S. companies or on the channels through which activists operate in these companies.

A couple of comparative studies investigating hedge fund activism mostly in Europe, where companies with concentrated ownership are more prevalent, found some evidence of activism. The most notable study by Marco Becht et al. covers nearly 1800 activist interventions in twenty-three countries,⁶⁰ and it documents activist interventions in countries with concentrated ownership, such as Belgium,

⁵⁸ As noted, the expected benefit from an activist intervention is a function of both the probability of success and the increase in the target share price as a result of the intervention. In theory, one could argue that since certain controlled companies enjoy strong insulation from market mechanisms, they are, on average, more likely to underperform, and therefore the higher expected returns from an activist engagement with these companies may compensate, at least partially, for the lower success rate. However, an activist will prefer to engage with a widely held firm if (i) target past performance is held equal or (ii) if the activist estimates the success probability of a campaign against a controlled company to be close to zero.

⁵⁹ Cheffins & Armour, *supra* note 22, at 68–69. The authors also note, however, that there can be exceptions, such as when minority shareholders have the right to select a director in a company that provides for “cumulative” voting for directors, or when the activist lobbies for the company to dismantle its dual-class share structure by buying out the special class of shares. *See also* Katelouzou, *Worldwide Hedge Fund Activism*, *supra* note 22.

⁶⁰ *See* Marco Becht, Julian R. Franks, Jeremy Grant & Hannes F. Wagner, *The Returns to Hedge Fund Activism: An International Study*, 1 (European Corp. Governance Inst., Working Paper, 2014) (researching interventions between 2000–2010).

Canada, France, Germany, Italy, the Netherlands, South Korea, and Sweden, although the number of activist incidents in those countries is still substantially lower than in the United States and the United Kingdom.⁶¹ Another recent study also shows that while activist interventions exist even in countries with concentrated ownership,⁶² the incidence of activism in those countries is significantly lower than in countries with dispersed ownership, such as the United Kingdom and Japan.⁶³

Other studies focus on hedge fund activism in specific European countries. For instance, Massimo Belcredi and Luca Enriques find that corporate governance reforms implemented in Italy over the last twenty years have increased the scope of hedge-fund activism with Italian public firms.⁶⁴ Similarly, Matteo Erede shows that activist funds made substantial investments, reaching a total value of more than \$3.5 billion in forty Italian-listed companies in early 2008,⁶⁵ the vast majority of which (thirty-three) are controlled.⁶⁶

⁶¹ *Id.* at 50 (see table noting the number of engagement in those countries).

⁶² See Katelouzou, *Myths and Realities of Hedge Fund Activism*, *supra* note 49, at 473–74; Katelouzou, *Worldwide Hedge Fund Activism*, *supra* note 22, at 43 (detailing the number of activist events in different European countries, including the following: Germany (thirty), France (twenty-five), the Netherlands (twenty), Italy (eleven), and Switzerland (ten). Activist events were also reported in Brazil, Spain and Sweden).

⁶³ Katelouzou, *Worldwide Hedge Fund Activism*, *supra* note 22, at 42 (presenting a sample of 432 activist campaigns, and finding that the United Kingdom and Japan dominate the sample, making up 53.47% of the total targets).

⁶⁴ Massimo Belcredi & Luca Enriques, *Institutional Investor Activism in a Context of Concentrated Ownership and High Private Benefits of Control: The Case of Italy* 14–15 (European Corp. Governance Inst., Law Working Paper No. 225/2013, 2014), <http://ssrn.com/abstract=2325421> [<http://perma.cc/L5BL-PT5M>] (observing 369 hedge fund transactions with Italian public companies between 2001 to 2013).

⁶⁵ Matteo Erede, *Governing Corporations with Concentrated Ownership Structure: An Empirical Analysis of Hedge Fund Activism in Italy and Germany, and Its Evolution*, 10 EUR. COMPANY & FIN. L. REV.

Another study exploring hedge fund engagements in Germany⁶⁷ used a sample of blockholders who possessed, on average, 36% of all outstanding shares.⁶⁸ The authors anticipated that the ability of hedge funds to restructure target firms might be weakened when other dominant shareholders invested in the target firm, since those shareholders are able to capture significant private benefits from the status quo, and thus have strong incentives to oppose hedge funds' demands.⁶⁹ Indeed, the authors found that engagements with firms with dominant shareholders had significantly lower short-term announcement returns.⁷⁰

Although the comparative studies mentioned in this Part clearly show that hedge fund activism is more prevalent in the United States than in countries with more concentrated ownership,⁷¹ it is unclear whether the variation in the level of activism across countries can be attributed to the differences in ownership structure or to other variables, such as financial, legal, and historical differences between those regimes and the United States.⁷² For instance, differences among countries regarding legal rules and in the intensity of law enforcement could have a major impact on the ease with

328, 356–59 (2013) (also noting that most of these funds are event-driven ones).

⁶⁶ *Id.* at 358.

⁶⁷ Wolfgang Bessler, Wolfgang Drobetz & Julian Holler, *The Returns to Hedge Fund Activism in Germany*, 1 EUR. FIN. MGMT 1, 116 (2013) (using a sample from 2000 to 2006). For an additional study on hedge funds activism in Germany, see Drerup, *supra* note 22 (finding that funds' investments are more probable if larger percentages of shares are considered as free float).

⁶⁸ Wolfgang Bessler, Wolfgang Drobetz & Julian Holler, *The Returns to Hedge Fund Activism in Germany*, 1 EUR. FIN. MGMT 1, 124 (2013) (providing data on ownership structure of hedge funds' target firms).

⁶⁹ *Id.* at 109.

⁷⁰ *Id.* at 136. The authors also show that total return is significantly higher if the dominant shareholder is a corporation. According to them, such blockholders (corporations) are less likely to oppose hedge funds' demands.

⁷¹ See Becht et al., *supra* note 60, at 50; Katelouzou, *Worldwide Hedge Fund Activism*, *supra* note 22.

⁷² See *infra* notes 73–76.

which shareholders can intervene in a target company. Some jurisdictions are friendlier to activists than others, and those differences may affect the number of activist events, as well as their probability of success.⁷³

Indeed, Dionysia Katelouzou examines the impact of legal rules on activism, and finds that the number of activist campaigns is larger in countries with stronger mandatory disclosure and shareholder protection regimes.⁷⁴ Similarly, Marco Becht et al. show that jurisdiction affects the level of activist engagements and their overall profitability,⁷⁵ although they acknowledge that such variation in activists' success rate to some degree is conditional on institutional characteristics of countries.⁷⁶

This Article takes a different approach from the above-mentioned comparative studies. First, it studies interventions in U.S. companies only, and compares the level of activism in controlled companies to that in widely held companies while creating a setting where most economic, legal, and cultural variables are the same. Second, and more importantly, this Article focuses not only on the potential effect of ownership structure on the level of activism, but also on the actual channels through which activism is deployed. Such examination is useful for understanding the dynamic between activist players and controlling shareholders, and may be important for policy makers

⁷³ See, Becht et al., *supra* note 60, at 11–17, 37–38. See also Belcredi & Enriques, *supra* note 64, at 5–6.

⁷⁴ Katelouzou, *Worldwide Hedge Fund Activism*, *supra* note 22, at 48–51, 61 (reporting that this difference is statistically significant at less than the 5% level. However, her results with respect to the advanced stages of activism provide little support to this view).

⁷⁵ Becht et al., *supra* note 60, at 11–17, 37–38.

⁷⁶ *Id.* at 37. These “institutional characteristics” include variation in the composition of the target’s ownership across countries, but also other historical, fiscal, jurisdictional or cultural differences. See also Amir N. Licht, *The Mother of All Path Dependencies: Toward a Cross-Cultural Theory of Corporate Governance System*, 26 DEL. J. CORP. L. 147, 152–57 (2001) (emphasizing the importance of national culture as an explanatory variable for differences in corporate governance systems).

interested in designing a regulatory solution to encourage activism in controlled companies.

III. HEDGE FUND ACTIVISM AND OWNERSHIP STRUCTURE

This Part tests the validity of the initial hypothesis presented in Part II by conducting a review of hedge fund engagements with controlled U.S. companies.

A. Data Collection

The data was collected in three stages. First, I collected data from SharkRepellent's database on activist engagements, mostly for the period from January 2005 through May 2014,⁷⁷ with public companies that were on the Russell 3000 index as of 2014. The Securities and Exchange Commission ("SEC") requires an investor to file a disclosure statement on Schedule 13D within ten days after acquiring 5% of a target's outstanding shares,⁷⁸ and those are monitored by SharkWatch, the corporate activism database of SharkRepellent.⁷⁹

⁷⁷ SharkWatch provides systemic data on corporate activism as of January 2005, though some data on proxy fights or engagements by certain prominent funds is available as of 2000, and was included in the sample.

⁷⁸ See 15 U.S.C. § 78m(d) (2012); 17 C.F.R. § 240.13d-1 (2011) (requiring beneficial owners of more than five percent of voting class of registered company's equity to file within ten days Schedule 13D, reporting acquisition and other information such as identity and background of acquirer and purpose of purchase).

⁷⁹ The data on activism from SharkWatch also contains information on events conducted by fifty significant activist investors even if these activists do not cross the 5% threshold, and thus are not subject to reporting requirements. Also, I excluded from the data "exempt solicitations," which are mostly employed by institutional investors and not hedge funds. Those solicitations, which are exempt from disclosure rules pursuant to Rule 14a-2(b)(1) of the Securities Exchange Act of 1934, 17 C.F.R. § 240.14a-2(b)(1) (2015), usually involve dissident communications to stockholders to persuade them to vote for or against a resolution.

In the second stage, I cross-referenced the activism data provided by SharkWatch with information obtained from SharkRepellent and FactSet on the “insider ownership”⁸⁰ of these companies, and their use of dual-class stock.

In the third and final stage, I expanded the pool of targets described in the preceding paragraphs by collecting and analyzing additional data from SharkWatch on historic activist engagements with controlled companies that are no longer in the Index and for which FactSet has available information on their historic insider ownership percentage, to create a sample of 209 activist events⁸¹ with 110 targets (the “Full Sample”).⁸² For each company on this Full Sample, I manually checked the data on insider ownership to correct discrepancies and confirm that a target has a controlling shareholder.⁸³ A company with a controlling shareholder is a company where at least 30% of the voting rights are held by one dominant shareholder or a group of affiliated holders (such as family members, co-founders, or shareholders with voting agreements).⁸⁴ I used this Full Sample to examine

⁸⁰ “Insider Ownership” measures the total percentage of common shares owned by the company’s executives, directors, or owners of 5% or more of the company’s common shares who are not institutional investors.

⁸¹ In most cases, an event is counted as a filing of a Schedule 13D and subsequent amendments. Occasionally, when the same activist conducts multiple campaigns in different years and files a new Schedule 13D, SharkWatch counts those multiple campaigns as separate events.

⁸² Although this sample does not constitute an exhaustive list of all activist engagements with Russell 3000 controlled firms, it covers a large number of these engagements.

⁸³ SharkRepellent’s data on “Insider Ownership” only measures the level of ownership concentration at a given company, but not necessarily the existence of a controlling shareholder. When a company has a number of unaffiliated shareholders, with each holding 5% to 10% of the company’s outstanding shares, the total percentage of insider ownership could be very high, despite the fact that the company does not have a dominant shareholder. For this reason, the data on the existence of a controlling shareholder had to be collected separately.

⁸⁴ I used a relatively high cutoff of insider ownership to confirm that the controllers of the sampled companies exercise an effective control over the companies’ voting rights, and that an outside shareholder cannot easily contest such effective control. Obviously, a dominant shareholder

certain alternative hypotheses related to activism in controlled companies, and to explore in greater detail the different channels through which activism is employed in controlled companies.

B. Results and Analysis

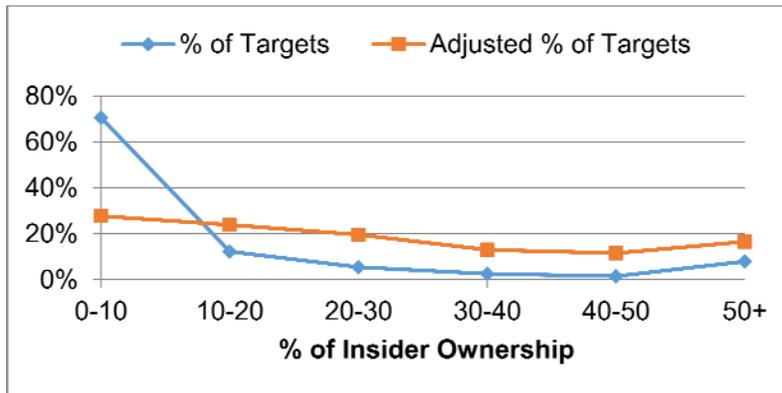
1. Activism and Ownership Structure

Figure 1 and *Table 1* below summarize the results of my examination. *Figure 1* plots the percentage of all Russell 3000 companies in 2014 that were subject to at least one activist event during the sampled period as a function of their insider ownership percentage. For each category of “insider ownership” (up to 10%, 10% to 20%, 20% to 30%, etc.), the “% of Targets” presents the percentage of targets subject to at least one activist event during the sampled period out of the total number of targets in the sample (654 companies), while the “Adjusted % of Targets” presents an adjusted percentage, controlling for the number of companies in the Russell 3000 Index in this category (such adjustment is required as companies with low insider ownership are more prevalent in the Index). For instance, 70.6% of the activist events were deployed against companies where

could exercise effective control over a company by holding less than 30% of the voting rights. *See, e.g., In re Zhongpin Inc. Stockholders Litigation*, C.A. 7393-VCN, 2014 WL 6735457 (Del. Ch. Nov. 26, 2014) (determining that a 17.5% stockholder could be deemed a controller). A Delaware court has also held that “there is no absolute percentage of voting power that is required in order for there to be a finding that a controlling stockholder exists.” *In re PNB Holding Co. S’holders Litig.*, No. Civ.A. 28-N, 2006 WL 2403999, at *9 (Del. Ch. Aug. 18, 2006). Instead, the Court considers whether or not the dominant stockholder “exercises ‘such formidable voting and managerial power that [it], as a practical matter, [is] no differently situated than if [it] had majority voting control.’” *In re Morton’s Rest. Grp., Inc. S’holders Litig.*, 74 A.3d 656, 665 (Del. Ch. 2013) (quoting *In re PNB*). *See also In re Cysive, Inc. S’holders Litig.*, 836 A.2d 531, 553 (Del. Ch. 2003); *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 70 (Del. 1989). For another academic study using a 30% cutoff, see Erede, *supra* note 65. For studies using lower cutoff, see La Porta et al., *supra* note 50; Faccio & Lang, *supra* note 50.

insider ownership is up to 10% of the outstanding common shares, but when controlling for the number of Russell 3000 companies in 2014 in this category, the percentage goes down to 27.7% (meaning that 27.7% of the firms where insiders own up to 10% of the outstanding shares have been subject to activism).

Figure 1: Activism and Insider Ownership



As expected, the likelihood of a company being subject to an activist intervention is negatively associated with the “insider ownership” variable. As ownership becomes more concentrated, the number of target companies declines dramatically. However, as reflected in *Figure 1*, when adjusted for the number of companies in each category of insider ownership, the differences in the intensity of activist events between the different insider ownership categories become smaller.

Table 1 compares activist engagements in controlled companies to those that are widely held, while controlling for the number of widely held and controlled companies in the Russell 3000 Index as of 2014. As *Table 1* shows, the likelihood that a controlled company will face an activist event is indeed lower than that of a widely held company. Only 14.9% of the controlled companies that were on the Russell 3000 Index in 2014 faced at least one activist event during the sampled period compared to 26.5% of the widely

held companies.⁸⁵ Interestingly however, although the increase in ownership concentration reduces the likelihood of activism, controlled companies are not fully insulated from activist interventions, and the total number of companies subject to activism is not negligible. I also explored the difference in the intensity of activism between widely held firms and controlled firms that have a dual-class share structure, a control-enhancing mechanism that is often used by U.S. controllers.⁸⁶ As *Table 2* shows, when I focus on this subset of controlled firms, the differences in the intensity of activist events between widely held and controlled companies become even smaller. Some 20.3% of all dual-class firms that were on the Russell 3000 Index in 2014 experienced at least one activist event during the sampled period compared to 26.5% of the widely held companies. In the next Part, I will explore the main cause behind the relatively high percentage of engagements with dual-class firms, and will show that is often facilitated by a formal right that certain dual-class firms grant minority shareholders.

Table 1: Activism with Widely Held and Controlled Companies

	Widely Held Companies	Controlled Companies	Controlled with Dual- Class
No. of Companies in the Index	2173	529	236
No. of Targets (as % of Companies in the Index)	575 (26.5%)	79 (14.9%)	48 (20.3%)

⁸⁵ This finding is also in line with a recent study on shareholder activism in the United States, showing that stock liquidity increases the probability of activism. See Oyvind Norli, Charlotte Ostergaard & Ibolya Schindele, *Liquidity and Shareholder Activism*, REV. FIN. STUD. 3 (forthcoming 2015).

⁸⁶ See *infra* note 185 and accompanying text.

Furthermore, this lack of absolute protection from activism becomes even more pronounced when looking at historical engagements with controlled targets that were included in the Russell 3000 index in previous years. As noted earlier, such review yields a sample of over 200 activist events with 110 targets. In sum, while controlled companies do enjoy some immunity from activist interventions, the data clearly show that this immunity is only partial. Activist players do target controlled companies as well, and this activity is far from trivial.⁸⁷

2. Different Type of Activism?

The previous Subpart showed that activists are also showing up at a non-negligible number of controlled companies, but this raw data does not tell us anything about the nature of those activist engagements. One could rightfully argue that engagements with controlled companies may differ substantially from those with widely held firms. For instance, activists engaging with controlled companies may primarily focus on governance changes, use only low-profile, collaborative strategies to achieve their goals, or pick easier targets. This Subpart examines these alternative hypotheses, using the Full Sample of activist engagements with controlled firms.

⁸⁷ One could argue the lower percentage of activist campaigns in controlled companies is not necessarily a direct result of an increased insulation due to their ownership structure, but instead a result of other factors. For instance, controlled companies might be less attractive targets if they are better managed than widely held companies, offering activists limited value-creating opportunities. In Part VI, I address this claim, showing it is unlikely that the *entire* decline in the level of activism is not associated, at least partially, with the ownership structure constraints. In particular, I argue that the mediocre performance of dual-class firms or family firms controlled by heirs of founders, as evidenced by numerous studies, suggests that a large number of controlled companies should be suitable targets for activism, assuming activism was not discouraged by ownership structure.

(i) *Different Type of Activist Engagements?* Some may think that most activist engagements with controlled companies are low-profile, non-hostile engagements, in which activists quietly persuade controllers to voluntarily accept their position. This possibility, however, is not supported by the data. I found that 31% of all open engagements are hostile (hostility includes a threatened or actual proxy contest or a lawsuit). This percentage of hostile interactions is similar to the one documented by Brav et al., using a sample of more than 1000 engagements.⁸⁸ Additionally, 27% of the public engagements are openly confrontational, although without reaching the level of a proxy fight.

I also rebut the possibility that activism in controlled companies is limited to governance-related matters. A review of all activists' demands shows that only 34% of them were related to the improvement of corporate governance provisions of the targets.⁸⁹ Activists, as I demonstrate in Part VI, are often dissatisfied with the way controllers manage their businesses, and a large number of their demands are related to core business and financial matters, such as demands to divest assets, initiate a capital restructuring, return cash via dividends or buybacks, review strategic alternatives, seek or block mergers, and so on. Occasionally, activist demands sought to influence the controlled companies from within via board representation (17% of the demands).

Finally, I found that the average ownership interest held by the activist (or a group of activists acting in concert) at the announcement of the campaign is 8.4%. These are not low-cost engagements. In fact, activists had to incur substantial costs while accumulating a non-negligible ownership stake in target companies.

⁸⁸ Brav et al., *Hedge Fund Activism*, *supra* note 15, at 1744.

⁸⁹ The information on activists' demands was collected from SharkWatch. The governance-related demands include, amongst others, demands to add independent directors, remove directors or officers, remove takeover defenses, and compensation-related enhancements.

(ii) *Different Type of Activist Players?* I examined the identity of the activists to confirm that the evidence on activism in controlled companies is not biased due to a high percentage of non-traditional activist investors who are less aware of the high risk involved in engaging with controlled companies. The data rebuts this possibility, showing that the vast majority of engagements in my Full Sample (86%) are conducted by the common activist players: hedge funds, activist investment advisors (such as GAMCO Asset Management, Southeastern Asset Management, and Franklin Mutual Advisers), and other financial institutions. Moreover, the activists in charge of 46% of the engagements in the Full Sample are included in the SharkWatch50 list (a list of fifty significant activist investors maintained by SharkWatch). Only 9% of the engagements are conducted by individuals, and the remaining 5% by corporations and other stakeholders.

(iii) *Picking Easier Targets?* Finally, it could be argued that activists will focus on “easier” targets—controlled companies whose controllers hold between 30% and 40% of the voting rights. This claim is also not supported by the data. *Table 2* shows that the majority of the engagements (57%) in the Full Sample are with companies where the controlling shareholders hold at least 50% of the voting rights. This result stays largely the same even when I focus on unique engagements and exclude subsequent related activist events from the Full Sample.⁹⁰ I also found that engagements with companies where the controlling shareholders hold at least the majority of voting rights have only a slightly lower success rate than engagements with companies whose controllers hold only 30% to 40% of the voting rights. As I show in the next Part, those successful engagements with fully controlled firms are often facilitated

⁹⁰ When activist X and activist Y target the same company around the same matter, but they do not act as a group, they have to file separate SC 13Ds. SharkWatch will count this interaction as two separate events. As the multiple engagements are often related, I count them, under this category, as one event to confirm the data is not biased.

by certain formal rights that increase activists' bargaining power.

Table 2: Activism and Controller's Ownership Percentage

	All CS Companies	CS (30–40%)	CS (40–50%)	CS (50% or more)
No. of Engagements	209 (100%)	59 (29%)	30 (14%)	120 (57%)
Success Rate ⁹¹	37.3%	40.7%	15%	40%

In sum, this Part presents data on the intensity and nature of hedge fund activism in controlled companies. It shows that activist shareholders are also showing up at a non-negligible number of controlled firms (although controlled companies are still more insulated from activism than widely held companies), and that these activist engagements are not substantially different in their nature from activism conducted in widely held companies. These unexpected findings trigger a question that stands at the heart of the Article: What mechanisms do activist hedge funds use when engaging with controlled companies? The next two Parts provide answers to this question.

IV. THE FORMAL CHANNELS OF ACTIVISM

To explore the main channels through which hedge fund activism is deployed against controlled companies, I closely reviewed 174 activist engagements against eighty-three controlled companies that were included in my Full Sample, and that had publicly disclosed the purpose of the activist engagement (the “Sample of Publicly-disclosed Engagements”). In many instances, activists' bargaining power vis-à-vis the controllers was not as limited as initially

⁹¹ An engagement is considered a successful one if one or more of the activist's demands is accepted by the target. Success rate is calculated as percentage of all unique engagements for which the results were publicly available.

anticipated. In particular, activists took advantage of a host of legal mechanisms, such as the ability to elect minority directors, veto certain M&A transactions initiated by the controller, or conduct activism in the shadow of litigation, which allow them to exert pressure on a controller. *Table 3* below provides a breakdown of activist engagements by each of these categories.

Table 3: Channels of Activism

	No. of Engagements	Percentage of Total ⁹²
Minority Directors in Dual-Class Firms ⁹³	47	27%
Minority Directors in Effectively-Controlled Firms	51	29%
Veto Rights in Going-private Transactions	24	14%
Lawsuits	8	5%
No Formal Channels	38	22%
Other	7	4%
Total	174	100%

⁹² The percentage stays substantially the same even when I focus on unique engagements and exclude subsequent related activist events from the Sample of Publicly-disclosed Engagements.

⁹³ This row includes all activist engagements with companies that provide minority shareholders with the ability to nominate and elect minority representatives to the board (regardless of whether or not such right is used by the activist). In more than 60% of these engagements (excluding related ones), the activists nominated or explicitly threatened to nominate their own candidates to the board, or at least tried to block the nomination of the controllers' representatives to the slate of directors appointed by minority shareholders.

A. The Right to Nominate and Elect Minority Directors

1. Dual-class Firms

Public shareholders in *certain* U.S. dual-class firms have the ability to nominate and elect minority representatives to the board. Although this mechanism has received little attention from legal scholars in the past, it is an important channel through which activism can be deployed in controlled U.S. firms. As shown in *Table 3*, this mechanism accounted for 27% of the Sample of Publicly-disclosed Engagements with controlled companies (forty-seven activist engagements), and it generated a high success rate.⁹⁴

There are essentially two types of controlled companies with a dual-class structure: companies where the controlling shareholder maintains control over the firm's voting rights through the use of shares with superior voting rights, and companies where the controlling shareholder has the right to elect a majority of the board, without necessarily controlling the majority of the company's voting rights, and the remaining directors are elected by other public shareholders. While the second type of dual-class structure enables a controller to elect the majority of the board without regard to its total voting power, that controller is still more vulnerable to activist attacks because activists have the ability to nominate and elect a short slate of directors. This bargaining mechanism, in turn, increases the *ex ante* incentives of activists to engage with controlled companies.

Although the election of the activist's director nominees to the board does not jeopardize the controller's ability to determine the company's business strategy, the mere presence of an outsider in the boardroom may change board dynamics.⁹⁵ This outside director, who is truly independent

⁹⁴ See *Table 4*.

⁹⁵ See, e.g., Yael Bizouati, *Activists Make More News: Two firms push for board seats at the New York Times*, INV. DEALERS' DIG. (Feb. 4, 2008) (quoting sources close to the activist hedge funds that engaged with The New York Times Company saying: "Change can happen with only one

of the controller and does not depend on the controller to be re-elected, has the right to access the company's books and records⁹⁶ and cannot be excluded from the board's intimate discussions (unless there is a direct, readily-apparent conflict of interest between the minority director and the controller).⁹⁷ A minority director can also spot conflict of interest transactions, challenge the controller with difficult questions, bring additional information and perspective to or from the boardroom to the activist shareholder who appointed him, and in non-hostile situations his voice and attitude with respect to the company's strategic plans or payout policies could affect the other independent directors. In addition, when there is a lawsuit of any kind, the minority director could be a "bad" witness for other directors, which in turn could increase the transparency of board discussions. Therefore, activists' reliable threat to elect a short slate of directors, and the concern from the presence of one or more "outside" directors on the board, may make controllers more attentive to activists' demands.

The activist campaign against The New York Times Company, presented in the beginning of this Article, was facilitated by the activists' ability to nominate minority directors. While the Times Company is controlled by the Sulzberger family through their ownership of Class B shares, allowing them to elect nine of the thirteen total board seats, shareholders unaffiliated with the controllers have the ability to elect the remaining four directors, and through this channel the activists put pressure on the controlling family.

member on the board This is not a numbers game, but a blend of who has the most experience and gravitas, and who works more.”).

⁹⁶ DEL. CODE ANN. tit. 8, § 220(d) (2011) (“Any director shall have the right to examine the corporation’s stock ledger, a list of its stockholders and its other books and records for a purpose reasonably related to the director’s position as a director”). See also J. Travis Laster & John Mark Zeberkiewicz, *The Rights and Duties of Blockholder Directors*, 70 BUS. LAW. 33, 44–47 (2015).

⁹⁷ Laster & Zeberkiewicz, *supra* note 96, at 33, 42–44, 59–60.

But The New York Times Company is not the only controlled company that has this arrangement in place.⁹⁸ Another interesting example is the engagement with Dillard's, Inc., an upscale department store chain. The engagement started in the middle of 2007, when Barington Capital Group, L.P., a minority holder in Dillard's, Inc., sent a series of letters to the company, expressing its extreme disappointment at the company's poor operational performance and corporate governance.⁹⁹ According to Barington, the company's loss for the second quarter of 2007 was the largest loss since 1992, and Dillard's, which was a thriving franchise under the leadership of its founder, lost approximately \$2 billion in market capitalization since his heirs had taken over in 1998.¹⁰⁰ As the pressure increased, the company announced in late 2007 a new plan to

⁹⁸ See, e.g., the successful engagements with targets such as Cablevision, Dow Jones, Emmis Communications, Forest City Enterprises, Inc., Media General, Inc., Stewart Information Services Corporation, TD Ameritrade Holding Corporation, Telephone and Data Systems, Inc., United States Cellular Corporation, and Whitney Information Network, Inc. I collected data on these engagements from the SharkRepellent database. See Factset Research Systems, Inc., SHARKREPELLENT.NET, <https://www.sharkrepellent.net> [<https://perma.cc/5DXG-7TPE>].

⁹⁹ See Press Release, Barington Capital Group, L.P., Barington Capital Group Seeks to Maximize Shareholder Value at Dillard's, Inc. (June 28, 2007), <http://www.prnewswire.com/news-releases/barington-capital-group-seeks-to-maximize-shareholder-value-at-dillards-inc-58531067.html> [<https://perma.cc/R4GQ-JK6U>]; Press Release, Barington Capital Group, L.P., Barington Capital Group Continues to Seek to Maximize Shareholder Value at Dillard's, Inc. (Aug. 3, 2007), <http://www.prnewswire.com/news-releases/barington-capital-group-continues-to-seek-to-maximize-shareholder-value-at-dillards-inc-57838437.html> [<https://perma.cc/K2Q6-Q5EL>].

¹⁰⁰ A report by the Institutional Shareholder Services ("ISS") supports this view, revealing that Dillard's had the second worst corporate governance profile of the 500 companies in the S&P 500 index. See Press Release, Barington Capital Group, L.P., Barington Capital Group Questions the Commitment of Dillard's to the Company's Public Stockholders (Aug. 30, 2007), <http://www.prnewswire.com/news-releases/barington-capital-group-questions-the-commitment-of-dillards-to-the-comp-anys-public-stockholders-58629562.html> [<http://perma.cc/PB2K-ZFSD>].

repurchase up to \$200 million of its shares held by minority holders.¹⁰¹

This was not enough. The activist player, who used its ability to nominate a minority director as a bargaining chip,¹⁰² kept pushing for change. In early 2008, the activist joined forces with other funds and insisted that further steps be taken to increase shareholder value and to improve the company's corporate governance.¹⁰³ The dissident group also gave formal notice to the company of its intent to nominate a four-person slate for election at the 2008 annual meeting.¹⁰⁴ Shortly thereafter, a settlement was reached between the parties, and the company agreed to nominate four candidates proposed by the activists.¹⁰⁵ Following this intervention, the family also took sizable cuts in compensation,¹⁰⁶ and, suggesting the market's support for these moves, Dillard's shares surged 35%, the biggest one-day percentage gain in twenty-eight years.¹⁰⁷

One can rightfully ask why controllers would voluntarily adopt such a dual-class structure that allows minority shareholders to get their representatives on the board. The answer to this question relates to past restraints that major U.S. exchanges imposed on the use of dual-class structures.¹⁰⁸ While the NYSE refused to list companies with a dual-class structure for approximately sixty years, up until

¹⁰¹ Dillard's, Inc., Current Report (Form 8-K) (Nov. 21, 2007).

¹⁰² The heirs of the company's founder control the election of eight out of twelve directors. Public shareholders elect the remaining four directors. See Dillard's, Inc., Proxy Statement (Form DEF 14-A) 5–6 (Apr. 22, 2008).

¹⁰³ Dillard's, Inc., Schedule 13D (Form SC 13-D) (Jan. 29, 2008).

¹⁰⁴ Dillard's, Inc., Schedule 13D (Form SC 13-D/A) (Mar. 19, 2008).

¹⁰⁵ Dillard's, Inc., Schedule 13D (Form SC 13-D/A) (Apr. 3, 2008).

¹⁰⁶ Arnold J. Karr, *Dillard Family Sees Compensation Drop in '08*, WOMEN'S WEAR DAILY, Apr. 22, 2009, at 14.

¹⁰⁷ *Dillard's Stock Up More Than 35 pct After Surprise Profit*, REUTERS (May 18, 2009), <http://www.reuters.com/article/dillards-stock-idUSN1836930420090518> [<https://perma.cc/FWR4-XHKX>].

¹⁰⁸ For a detailed account of the history of dual-class capitalization in the United States, see Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 693–707 (1986).

the mid-1980s,¹⁰⁹ the AMEX adopted a more flexible policy with respect to disparate voting rights. In 1976, the AMEX agreed to list a dual-class firm, named Wang Laboratories, Inc., that went public with a structure that, among other things, grants holders of shares with inferior voting power the right to elect 25% of the board of directors.¹¹⁰ The AMEX subsequently published the essence of the prelisting understandings with Wang Laboratories in the form of a statement of policy, called the “Wang formula.”¹¹¹

After Wang and up until 1985 (when major U.S. stock exchanges relaxed their restrictions on dual-class stock), twenty-two dual-class firms that went public on the AMEX used this formula, and seven additional firms that had disproportionate voting rights before 1976 have recapitalized employing the Wang formula.¹¹² Therefore, up until the mid-1980s, controllers who wanted to use a dual-class structure in order to maintain control over the company even when they liquidated some of their position had no choice but to provide public holders with the right to elect minority directors. Moreover, in this pre-activist era, controllers who adopted this special structure¹¹³ probably did not anticipate that activist investors would ever take advantage of it to launch campaigns against them.¹¹⁴ Upon the rise of activism,

¹⁰⁹ Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807, 807–08 (1987).

¹¹⁰ Seligman, *supra* note 108, at 704 n.90.

¹¹¹ *Id.*

¹¹² *Id.* See also M. Megan Partch, *The Creation of a Class of Limited Voting Common Stock and Shareholder Wealth*, 18 J. FIN. ECON. 313 (1987) (examining forty-four publicly traded firms that created a class of limited voting common stock during 1962–1984, and showing that in thirty-four cases each class separately elects a certain percentage of the board of directors, which reflects AMEX guidelines).

¹¹³ Note that most of the controlled companies that adopted this special dual-class structure did so before 2005, when the phenomenon of hedge fund activism gained steam. See *infra* note 212.

¹¹⁴ For instance, when activist holders engaged with The Times Company in 2008, it was the first time the company’s directors were ever nominated by shareholders unaffiliated with management. See Richard

this special dual-class structure became an important channel of activism, and companies that adopted this structure were *twice* as likely to be subject to an activist intervention than a dual-class company without any special arrangement. A review of a sample of 193 dual-class firms shows that 43% of all dual-class firms that grant public shareholders the right to nominate a minority director experienced at least one activist event during the sample period compared to 20% of all dual class firms without such structure.¹¹⁵

This relationship between shareholder activism and the ability of activist holders to elect minority directors is also supported by evidence from Italy, where a regulation passed in 2007 allowed minority holders to appoint their own directors via proportional voting.¹¹⁶ Matteo Erede, who researches shareholder activism in Italy, shows that hedge funds have actively intervened in half of the elections in Italian-listed companies that are subject to the 2007 regulation, which allows minority holders to appoint their own directors.¹¹⁷

2. Effectively-controlled Firms

Activists may also threaten to challenge an “effective” controller, who owns less than 50% of the voting power, by seeking board representation despite the low *ex ante* chances of winning a proxy fight against an effective controller.

Pérez-Peña, *Investor to Step Down From Times Co. Board*, N.Y. TIMES: DEALBOOK, Feb. 19, 2010, at B8.

¹¹⁵ Data on dual-class firms is as of 2012 and was taken from SharkRepellent. Information on the ability to elect minority directors was hand-collected. The sample includes 60 dual-class firms that grant public shareholders the right to nominate a minority director and 133 dual-class firms without such structure.

¹¹⁶ Erede, *supra* note 65, at 359.

¹¹⁷ *Id.* at 358–59. 82.5% of these Italian targets are controlled ones. *See also* Belcredi & Enriques, *supra* note 64, at 21–23, 30 (noting that hedge funds and mutual funds have submitted slate voting for corporate bodies on various occasions).

Controllers are often incentivized to partially liquidate their equity position below the 50% threshold, as it enables them to diversify their holdings, reduce their idiosyncratic risk, and raise new capital while still controlling their companies.¹¹⁸ In the ordinary course of business, maintaining between 30% and 50% of the voting rights should allow controllers to exercise effective control. This is especially true considering retail investors' rational apathy problem, and their tendency to avoid voting.¹¹⁹ Consider a situation where the largest shareholder owns 35% of the firm's voting rights and 15% of the investors avoid voting. In such a case, an activist nominee needs to attract the support of more than 70% of the public shareholders not affiliated with the controller in order to be elected.¹²⁰ Moreover, in order to pass a shareholder proposal with a simple majority vote, an activist has to receive the support of *all* shareholders not affiliated with the controller.¹²¹

However, an activist engagement against an effectively controlled company is not necessarily a lost cause. Controllers' effective control may be challenged, but only if the activist receives the overwhelming support of shareholders unaffiliated with the controller.¹²² Since there

¹¹⁸ See, e.g., George W. Dent, Jr., *Dual Class Capitalization: A Reply to Professor Seligman*, 54 GEO. WASH. L. REV. 725, 749 (1986); Gilson, *supra* note 109, at 812.

¹¹⁹ See Kobi Kastiel & Yaron Nili, *In Search of the "Absent" Shareholders: A New Solution to Retail Investors' Apathy*, 40 DEL. J. CORP. L. (forthcoming 2016) (manuscript at 8) (showing that in 2014, 24% of the shares in the S&P 500 were not voted).

¹²⁰ The public float after excluding the controller's stake (35%) and the shares held by shareholders who do not exercise their vote (15%) is 50%. Since the activist has to receive at least 35.1% of the votes in order to win the contested election, it will need the support of approximately 70% of the shareholders not affiliated with the controller (35.1/50).

¹²¹ Since the public float after excluding the controller's stake and non-voting shares is 50%, all shareholders will have to support the proposal so that it will pass.

¹²² The chances of a successful challenge depend on certain factors, including investors' turnout rate at the annual meeting, the size of the activist's stake, and the controller's ownership percentage. As the

is some uncertainty regarding both the turnout rate among institutional and retail investors and how they will exercise their vote, it is difficult to determine *ex ante* whether a campaign will succeed. Concerns that effective control will be contested in a perfect-storm scenario, as well as the potential damage to controller's reputation,¹²³ could push a controller to accept activists' demands, even when the actual chances of a campaign's success are low.

The activist engagement with Comcast in 2008 exemplifies this point. Although the Roberts family holds 33% of the outstanding voting rights,¹²⁴ the family's effective control over Comcast could not be easily contested. In the four-year period prior to the engagement, all twenty-three shareholder proposals that were submitted to the company failed.¹²⁵ This data suggests that the chances of an activist shareholder winning a proxy fight against the Roberts family were ostensibly low, but the mere existence of some possibility of challenging the controlling family put pressure on the company and motivated it to accept some of the activist's demands. Indeed, as a result of the engagement, Comcast agreed to pay a quarterly dividend—its first dividend since 1999—and to utilize its remaining \$6.9 billion share repurchase authorization by the end of 2009.¹²⁶ In addition, the company eliminated a controversial benefit to

controller's stake increases from 30% to 50%, the likelihood to win a proxy fight decreases.

¹²³ See the discussion in Part V, *infra*.

¹²⁴ Comcast Corp., Proxy Statement (Form 14-A) 5 (Mar. 17, 2008) (stating that the shares beneficially owned by Mr. Brian L. Roberts represent 33.33% of the combined voting power of the company).

¹²⁵ Most of those proposals were governance- or compensation-related proposals that usually receive strong shareholder support. The data on shareholder proposals submitted to Comcast was collected from the SharkRepellent database. See Factset Research Systems, Inc., SHARKREPELLENT.NET, <https://www.sharkrepellent.net> [<https://perma.cc/5DXG-7TPE>].

¹²⁶ Comcast Corp., Current Report (Form 8-K) 1 (Feb. 14, 2008).

the estate of the company founder upon his death, and reduced bonuses for certain executive officers.¹²⁷

Finally, activist engagements with controlled companies could also be motivated by the existence of a second-largest holder who opposes the controller and who could create a coalition with the activist to facilitate the engagement. In this type of situation, although the controlling shareholder exercises an effective control over the company by holding 30% (or more) of the voting rights, its effective control could more easily be contested due to the existence of an additional holder with a substantial ownership percentage. This dynamic is particularly common when there is a dispute between the company's major holders and the activist takes advantage of this conflict to co-operate with one side.¹²⁸

More generally, as *Table 3* shows, 29% of the engagements in the Sample of Publicly-disclosed Engagements were with controlled companies whose controllers exercised effective control,¹²⁹ and the activists had no ability to press controllers through other legal

¹²⁷ *Id.* Another interesting example is the activist engagement with Barnes & Noble that is controlled by the Riggio family. In March 2010, after being subject to continuing pressure by Yucaipa American Management, the company removed its CEO and a member of the controlling family, Stephen Riggio. Barnes & Noble, Inc., Current Report (Form 8-K) 1 (Mar. 18, 2010). Later on, although Yucaipa's proxy fight failed, Barnes & Noble, Inc., Current Report (Form 8-K) 1 (Oct. 13, 2010), the pressure on Barnes & Noble continued in subsequent activist campaigns; one of them urged the company to spin off its Nook business, and indeed in April 2012, the company agreed to sell a 17.6% stake in the Nook business to Microsoft. Barnes & Noble, Inc., Current Report (Form 8-K) 1 (Dec. 28, 2012).

¹²⁸ Belcredi & Enriques, *supra* note 64, at 25–27 (describing examples where the control block is scattered among members of the controlling group and the dispute between them triggers the activist engagements). Notable examples include the activist engagements with Benihana Inc., Morgans Hotel Group Co., Private Media Group, Inc., and Synovics Pharmaceuticals, Inc. I collected data on these engagements from the SharkRepellent database. See Factset Research Systems, *supra* note 125.

¹²⁹ I define an effective controller as a controller who holds up to 45% of the voting rights. Such controller is practically entrenched since the average shareholder turnout at the sampled companies is lower than 90%.

channels. In 45% of the cases (excluding related ones), the activists sought board representation or asked to add an independent director. Board seats were granted in approximately half of these challenges, with all but two cases settled in advance.

B. Minority's Veto Power in Going-private Transactions

Activism in connection with public merger and acquisition (“M&A”) transactions has long been an important channel through which activists generate returns for their investors.¹³⁰ The main M&A-related strategies involve directly challenging an announced deal in an effort to extract a higher price from the purchaser or defeating a transaction at a price that significantly undervalues the shares held by the public shareholders. Those strategies prove effective even in the context of controlled companies, mostly when a going-private transaction needs to be approved by a majority of minority shareholders. Such veto power provides activist investors with the ability to extract a higher deal premium from a controlling shareholder or block a merger at a depressed offering price.

In certain jurisdictions, such as Delaware, controllers are not required by law to get the approval of the majority of minority shareholders before consummating a conflicted going-private transaction. However, Delaware courts incentivize controllers to seek such approval. Until recently, an informed vote of a majority of the minority shareholders shifted the burden of proof under the “entire fairness” standard from the defendant to the plaintiff,¹³¹ and a recent

¹³⁰ See, e.g., Greenwood & Schor, *supra* note 38; Morrison & Foerster LLP, *Activist Hedge Funds Find Ways to Profit from M&A Transactions*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (June 4, 2014), <http://blogs.law.harvard.edu/corpgov/2014/06/04/activist-hedge-funds-find-ways-to-profit-from-ma-transactions/#more-63772> [<http://perma.cc/7XNU-9LFS>].

¹³¹ Where a transaction involving self-dealing by a controlling stockholder is challenged at court, the applicable standard of judicial review is “entire fairness,” with the defendants having the burden of

Delaware decision in *Kahn v. M & F Worldwide Corp.* (“*MFW*”) further intensified those incentives by allowing controllers who seek such approval (as well as approval by a well-functioning committee of independent directors) to avoid onerous entire fairness scrutiny and be subject instead to “business judgment” review.¹³²

Critics of *MFW* often argue that giving shareholders the additional protection of a majority-of-minority vote adds little value because shareholders who suffer from information asymmetry will always vote for a good premium deal offered by the controller.¹³³ This criticism, however, misses an important implication of *MFW*: its potential indirect impact on hedge fund activism. Even if most minority shareholders lack the ability to gather information and closely analyze the suggested deal terms, the use of a legal rule that incentivizes controllers to provide minority holders with veto power over conflicted transactions allows activist shareholders to extract a higher premium in going-private transactions (usually suspected to be conducted at a depressed price)¹³⁴ to the benefit of *all* shareholders. Finally,

persuasion. *See, e.g.*, *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983); *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997). However, until recently, approval by either a well-functioning committee of independent directors or an informed vote of a majority of the minority stockholders shifts the burden of proof under the entire fairness standard from the defendant to the plaintiff. *See Kahn v. Lynch Commc’n Sys., Inc.*, 638 A.2d 1110 (Del. 1994).

¹³² *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) (holding that a controlling stockholder’s related party transaction will be subject to the business judgment rule if a proposed transaction receives both the affirmative recommendation of a (fully authorized and effectively functioning) special committee and approval by a majority of the minority stockholders).

¹³³ *Id.* at 643 (citing plaintiffs’ argument regarding minority investors’ tendency to sell their shares for a premium).

¹³⁴ For a theoretical analysis of this point, see Lucian Arye Bebchuk & Marcel Kahan, *Adverse Selection and Gains to Controllers in Corporate Freezeouts*, in *CONCENTRATED CORPORATE OWNERSHIP* 247 (Randall K. Morck ed., 2000). For evidence showing that when controllers do not have to seek the approval of majority of minority shareholders or of a special committee of independent directors the merger consideration to minority

even if the controller does not seek an approval by the majority of disinterested shareholders, an activist holder can still put pressure on the controller by seeking an appraisal remedy.¹³⁵ This mere threat of litigation provides the activist player with additional bargaining power.

The data include twenty-four M&A-related events, and this mechanism accounts for fourteen percent of the Sample of Public-disclosed Engagements. In most of the engagements with observable outcomes, the activists either forced controllers to sweeten the offering price or to modify the transaction terms in a way that benefitted all minority shareholders (58%), or they blocked a transaction at what they perceived as an undervalued price (34%).¹³⁶ The high success rate of M&A-related engagements¹³⁷ shows that the ability of minority shareholders to veto certain transactions is another important channel of activism in controlled companies. A notable recent example is the acquisition of Clearwire Corporation by one of its controlling shareholders, Sprint. The activist engagement in this acquisition led to a

shareholders decreases, see Guhan Subramanian, *Post-Siliconix Freeze-Outs: Theory and Evidence*, 36 J. LEG. STUD. 1 (2007) (finding that minority shareholders receive lower cumulative abnormal returns in tender-offer freeze-outs that were not subject to entire fairness standard than in statutory merger freeze-outs).

¹³⁵ See Morrison & Foerster LLP, *supra* note 130.

¹³⁶ An interesting example is the engagement with the Dolan family, back in 2007, following the controlling family's decision to take Cablevision private by acquiring the shares held by the public shareholders. The activist's pressures led the Dolan Group to sweeten the offering price, from \$27 to \$36.25 per share. Eventually, although the Dolan Group controlled the majority of the company voting rights, the activist, who still thought that the deal price undervalued the minority holders' shares, was successful in its efforts to block the transaction as the merger required the approval of a majority of the minority shareholders. See Press Release, Cablevision Systems Corporation, Cablevision Announces Preliminary Vote Results from Special Shareholders Meeting (Oct. 24, 2007), <http://www.businesswire.com/news/home/20071024005915/en/Cablevision-Announces-Preliminary-Vote-Results-Special-Shareholders> [<https://perma.cc/9VWW-HW63>].

¹³⁷ The activists' demands were fully rejected in only 8% of these M&A-related engagements.

significant increase in the final purchase price from \$2.90 per share to \$5.00 per share.¹³⁸

Minority protections in the context of public takeovers also play an important role in Germany, where there has been a noticeable increase in the frequency of activist engagements.¹³⁹ In particular, activist hedge funds have begun to take advantage of certain provisions of the German Stock Corporation Law, which provides minority holders with the right to challenge the appropriateness of the consideration paid to them when being squeezed out pursuant to a domination agreement with a buyer who holds at least 75% of the share capital of a target. In recent years, this right serves as an important channel of activism for hedge funds, including United States-based funds such as Elliott Management.¹⁴⁰

C. Activism in the Shadow of Litigation

An activist can also exert pressure on a controller by filing a lawsuit against a controlled company. Alternatively, once an activist campaign begins, the use of lawsuits can prevent a controller from taking advantage of its power to take unilateral steps against the activists.¹⁴¹ I documented

¹³⁸ See Michael J. de la Merced, *Sprint Beats Dish's Latest Bid for Clearwire*, N.Y. TIMES: DEALBOOK, June 21, 2013, at B6.

¹³⁹ See *supra* notes 67–70.

¹⁴⁰ See, e.g., Bessler et al., *supra* note 67; Morrison & Foerster LLP, *Shareholder Activism in Germany*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (June 7, 2014), <http://blogs.law.harvard.edu/corpgov/2014/06/07/shareholder-activism-in-germany/> [<http://perma.cc/GL83-CTVR>].

¹⁴¹ In a notable example, an activist filed a lawsuit for a breach of fiduciary duties against the directors of Syms Corp., a chain of “off-price” apparel stores with a controller who holds 56% of the voting rights, seeking to enjoin the board from taking unilateral steps and voluntarily delisting the company public shares from trading on the NYSE. This strategy worked, and a month later, the company announced it was reregistering its common stock with the SEC in light of significant activism. See Press Release, Barington Capital Group, L.P. and Esopus Creek Advisors LLC, *Stockholder Group Urges Syms Corp not to Deregister or Delist Company's Common Stock* (Jan. 2, 2008), <http://www.prnewswire.com/news-releases/stockholder-group-urges-syms-corp-not-to->

eight engagements where activists filed, or threatened to file, lawsuits not in the M&A context discussed above, and they were successful in 37% of these cases.

One of these cases was the engagement of Stilwell Group with Prudential Bancorp, Inc., a company whose controller holds 55% of the company's voting power. Back in 2008, the activist filed a lawsuit against the company, seeking to remove a director that the activist thought was too old and ill to perform his duties properly, to hold the company directors personally responsible for costs associated with defending the lawsuit, and to stop the directors from attempting to self-adopt stock benefit plans against the wishes of the shareholders.¹⁴² This pressure resulted in the director's resignation and a settlement agreement pursuant to which the company agreed to commence a share repurchase program, or otherwise to appoint one activist nominee to the board.¹⁴³

This Part shows that activists' bargaining power vis-à-vis the controllers is not as limited as initially anticipated. In particular, activists have enhanced power when they are able to nominate and elect minority directors or to veto certain M&A transactions initiated by the controllers. But what happens when public shareholders have no formal, legal mechanisms to facilitate engagements? To what extent could the reputational concerns of controlling shareholders replace the formal channels that facilitate activism? The next Part will explore those questions.

deregister-or-delist-companys-common-stock-56766247.html [http://perma.cc/2DYY-JFLG].

¹⁴² Prudential Bancorp, Inc. of Pennsylvania, Schedule 13D (Form SC 13D) 8–14 (May 19, 2008).

¹⁴³ See Jeff Blumenthal, *Prudential Bancorp Director Quits Amid Insider Complaint*, PHILA. BUS. J. (June 18, 2008), <http://www.bizjournals.com/philadelphia/stories/2008/06/23/newscolumn2.html> [https://perma.cc/5L3M-3N64].

V. THE INFORMAL CHANNELS OF ACTIVISM

While legal scholars have often emphasized the important role that informal channels—particularly reputational concerns of controlling shareholders—play in curbing controllers’ opportunism,¹⁴⁴ there is little empirical evidence that examines this proposition. Engagements with controlled companies, and especially those where the control is uncontested, serve as an interesting setting to explore the potential impact of reputational concerns for two reasons. First, since activists have a limited ability to formally influence the decision-making of a fully controlled firm, one could assume that when activists do decide to target controlled companies, they are likely to rely more heavily on informal mechanisms. Second, controlling shareholders, who usually hold their position for a long period of time, are considered better targets for reputational sanctions than hired managers of widely held firms, as the former’s ability to influence the firm’s decision-making is sufficiently identifiable to investors and the public.¹⁴⁵ To explore the potential role of reputational forces, this Part conducts two main examinations. First, it reviews engagements when control is fully uncontested and activists have no other apparent formal bargaining mechanisms (“against all odds” engagements). Second, it examines engagements that receive particularly strong media coverage, and thus are likely to have a greater impact on the controller.

A. Unbundling Controllers’ Reputational Concerns

In general, the incentives of controllers to preserve their reputation stem from different sources. One source is the

¹⁴⁴ See *infra* notes 145–49.

¹⁴⁵ Ronald J. Gilson, *Controlling Family Shareholders in Developing Countries: Anchoring Relational Exchanges*, 60 STAN. L. REV. 633, 636 (2007); see also Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 783–84, 815, 858 (2005) (arguing that controlling shareholders like Henry Ford who are heavily involved in the management of their firms are “the best locus of social and moral sanctions”).

potential damage to the public image or social standing of controllers as successful managers among their peers.¹⁴⁶ After all, senior managers and directors of large, public U.S. corporations make up a surprisingly small and close-knit community. Since those people know each other well, as Edward Rock suggests, they “apparently care about their reputation in the community.”¹⁴⁷ A second related concern focuses on the potential damage to controllers’ reputation when treating minority shareholders unfairly. In that regard, a controller’s need to maintain “a positive image as an honest and moral dealer”¹⁴⁸ may play an important role in reducing the risk of minority expropriation, causing controllers “to refrain from abusing the rights of the minority—even when no economic sanction is threatened.”¹⁴⁹ The third aspect of reputation markets is related to the public image of a controlled company among its consumers and the general public. For a company with a large consumer base, a campaign that publicly criticizes the company’s policy toward social and environmental issues could negatively impact its reputation and reduce the demand for its product.

¹⁴⁶ See, e.g., Alexander Dyck & Luigi Zingales, *The Corporate Governance Role of the Media*, in *THE RIGHT TO TELL: THE ROLE OF THE MEDIA IN DEVELOPMENT* 107, 109, 122 (World Bank ed., 2002) (discussing the disciplinary power of media coverage on executives’ reputation); see also Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 *STAN. L. REV.* 857, 865–66 (1993) (arguing that symbolic gesture of withholding votes could be enough of an embarrassment to motivate the board to take certain disciplinary action).

¹⁴⁷ See Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 *UCLA L. REV.* 1009, 1013–14 (1997).

¹⁴⁸ Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 *CAL. L. REV.* 393, 425 (2003).

¹⁴⁹ *Id.* See also John C. Coffee, Jr., *Do Norms Matter? A Cross-Country Evaluation*, 149 *U. PA. L. REV.* 2151, 2175 (2001) (claiming that social norms do matter and constrain controllers to varying degrees); Ronald J. Gilson, *supra* note 145, at 648 (2007) (noting that some extraction of private benefits of control must be given up by the controller to signal minority shareholders that they will be treated fairly); Dyck & Zingales, *supra* note 24, at 576–79 (presenting the extra-legal institutions that help to curb private benefits of control by controlling shareholders).

Hedge fund campaigns, by and large, focus on the first two aspects of reputation markets. As such, the activists' public statements often criticize controllers' decision-making or highlight their abusive behavior toward minority shareholders. Of the 209 activist events in my Full Sample, only one campaign involved a social matter that was more likely to influence the perception of the target's consumers. That was the campaign initiated by The Humane Society of the United States, advised by Carl Icahn, against Tyson Foods, one of the world's largest processors and marketers of meat, which criticized the company's treatment of animals.¹⁵⁰

The effectiveness of reputational markets also varies based on the type of sanction. For example, labor market sanctions¹⁵¹ do not play a meaningful disciplinary role in the context of controlled companies, as entrenched controllers (or directors nominated by them) are unlikely to face a real risk of removal even if they perform poorly.¹⁵² However, reputational sanctions could have a greater deterrent effect on a controlling shareholder than on a professional, hired manager when it comes to the financial damages caused by the decrease in the company share price. A negative campaign that successfully targets controllers' skills or their attitude toward minority shareholders could result in a decreased firm share price. Since a controlling shareholder usually holds a larger equity stake in a target than a professional manager, they incur greater financial damages as a result of a drop in the firm share price.¹⁵³

¹⁵⁰ Tyson Foods, Inc., Proxy Statement (Form 14A) (Oct. 2, 2012).

¹⁵¹ See, e.g., Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1488 (2007).

¹⁵² See, e.g., Zohar Goshen, *Controlling Corporate Agency Costs: A United States-Israeli Comparative View*, 6 CARDOZO J. INT'L & COMP. L. 99, 112 (1998).

¹⁵³ Note however that a significant number of controllers use control-enhancing devices that allow them to maintain their control while holding only a small fraction of the equity interest (see *infra* note 185), and thus the financial damage that they incur would be lower in that scenario than in the case of a controller who does not use such devices.

In sum, reputation markets could affect controlling shareholders in two different ways: either directly, by undermining the professional image of the controller in the business community, or indirectly, by depressing the target share price. The need to avoid (or mitigate) those reputational harms and the accompanying financial damages may, if reputation markets operate effectively, push controllers to be more attentive to activists' demands, and put additional pressure on controllers to settle with activists, even in cases where the activists have no apparent formal bargaining power.

B. The Role of Reputation in Encouraging Activism

1. Activism Against All Odds

To assess the potential impact of reputation markets, this Subpart focuses on the most extreme type of activism against controlled companies—engagements where the control is fully uncontested—and activists have no other formal bargaining mechanisms. I define “against all odds” engagements as ones that meet the following criteria: (i) the controlling shareholder exercises actual control over the firm by holding close to 50% (or more) of the firm's voting rights, and (ii) the activists have no ability to elect minority directors or veto related-party transactions, nor do they have an apparent legal claim against the company.

This setting of “against all odds” activism sheds an interesting light on the role reputational and extra-legal forces play by disentangling the impact of reputation from other formal forces. If one assumes that reputational concerns, when operating alone, are not effective enough in disciplining controllers, then one would not expect to see any engagements with companies that meet the above-mentioned criteria, nor would one expect that the controlling shareholder would be attentive to the demands of activists when the engagement is done against all odds.

I documented thirty-eight “against all odds” activist engagements with controlled companies, accounting for 22%

of the Sample of Publicly-disclosed Engagements.¹⁵⁴ It is difficult to know what exactly motivated the activists to start an engagement when they had no apparent formal bargaining mechanisms.¹⁵⁵ However, since the vast majority of these cases involved public criticism of the governance or business strategy of the controlled companies,¹⁵⁶ it may well be the case that reputational concerns or other extra-legal pressures motivated these “against all odds” engagements.¹⁵⁷ Moreover, in a handful of these “against all odds” engagements, controllers agreed to some of the activists’ demands to nominate independent directors,¹⁵⁸ distribute

¹⁵⁴ The percentage is calculated out of 174 engagements included in the Sample of Publicly-disclosed Engagements.

¹⁵⁵ At any rate, even when the engagements have limited scope and they include only a public letter to the board (and a few engagements in my Full Sample were of that fashion), the activists still have to incur significant costs associated with identifying potential targets and accumulating a large equity position.

¹⁵⁶ Approximately 78% of these “against all odds” engagements (excluding related ones to avoid biases) included a public criticism of the controllers. In those cases, activists urged the targets to initiate strategic alternatives (nine events), to appoint directors recommended by the activists (seven events), to return cash to shareholders (six events), and to improve governance practices and remove takeover defenses (six events).

¹⁵⁷ In only six of the “against all odds” engagements, the activists either did not disclose the purpose of the engagement or used relatively neutral language in their public statements without directly criticizing the controller. Standing out in that regard is the activist hedge fund ValueAct, which is known for the use of soft activism. ValueAct managed to appoint its nominees to the boards of three different targets whose controllers held more than 50% of the voting rights. *See* Martha Stewart Living Omnimedia, Inc., Schedule 13D (SC 13D) (Jan. 18, 2002); Allison Transmission Holdings, Inc., Current Report (Form 8-K) (Dec. 15, 2014); Steinway Musical Instruments, Inc., Current Report (Form 8-K) (Jan. 31, 2008). However, since its communications with the targets are not publicly disclosed it is impossible to know whether the decision to accept activists’ demands was motivated by reputational concerns or by other reasons, such as the controller’s true belief that the activists’ plan could increase the share value.

¹⁵⁸ An interesting example in that regard is the high-profile engagement with Meredith Corporation, a media conglomerate. Back in 2001, the activist, Franklin Mutual Advisers, expressed its dissatisfaction with the excessive management compensation, the overall performance of

additional dividends,¹⁵⁹ and enhance governance standards,¹⁶⁰ even though the activists had no apparent bargaining mechanism. The desire to put an end to public activists' interventions focusing on the targets' problematic management or governance practices may have motivated controllers to be more attentive to shareholders' demands in those cases.

Despite those few successful examples, the overall disciplinary effect of reputational forces as they relate to the implementation of activists' demands is fairly limited. As reflected in *Table 4* below, the implementation rate of activists' demands is substantially higher in cases where the activists use a formal bargaining mechanism in addition to the reputational threat than it is in just "against all odds" cases. This disparity suggests that when activists have no formal bargaining chip, such as the ability to elect board

the board, and "chronic undervaluation" of the target, and recommended certain strategic changes and the nomination of directors with financial expertise. This pressure bore fruit. In 2001, Meredith named one dissident member to its board and its stock price jumped about 50% during the three-year period following the intervention. *See* Franklin Mutual Advisers, LLC, Schedule 13D (SC 13D) (Jan. 31, 2001); *Meredith Is Urged To Split Operations By a Big Investor*, WALL. ST. J., Feb. 1, 2001, at B7. In another case, Calamos Asset Management, Inc., a majority-controlled company, decided, following an activist campaign that took place in 2012, to add two new independent directors, to increase its quarterly dividend, and to announce a three million share repurchase program. *See* Calamos Asset Management, Inc., Current Report (Form 8-K) 2 (Aug. 28, 2012); Calamos Asset Management, Inc., Current Report (Form 8-K) 2 (Feb. 4, 2013).

¹⁵⁹ *See* Calamos Asset Management, Inc., Current Report (Form 8-K) 2 (Feb. 4, 2013).

¹⁶⁰ In 2005, an activist holder sent public letters to NASDAQ, criticizing the poor corporate governance of Alico, Inc. and the conflict of interest between the company chair's responsibilities at Alico and another private company that owned 48% of Alico. *See* Alico, Inc., Schedule 13D (SC 13D) (Mar. 1, 2005). Following those pressures, the target disclosed a new outline of Governance Standards, which included the resignations of directors with ties to the parent board, the separation of the positions of Chairman and CEO of Alico, and the commitment that the parent company will not raise its ownership interest in Alico to more than 55%. *See* Alico, Inc., Current Report (Form 8-K) (Mar. 22, 2005).

members or to veto certain transactions, controllers are more likely to ignore their demands.¹⁶¹

*Table 4: Success Rate*¹⁶²

	Minority Directors	Effective Controller	M&A Activism	Lawsuits	No Formal Bargaining Mechanism ¹⁶³
Success Rate	51%	39%	83%	37%	11%

The results presented in *Table 4* are further corroborated by running a linear probability regression, presented in *Table 5*, where success of an engagement is the dependent variable (1=at least one of the activist's demands is accepted; 0=all activist's demands are rejected) and the existence or non-existence of a formal bargaining mechanism is the independent variable (0=activist engagement with no formal bargaining mechanism; 1=engagement with a formal bargaining mechanism). I found that non-existence of a formal bargaining mechanism produces a negative and statistically significant effect on the probability that an activist's demand is accepted (Column 1) after controlling for the target firms' industry and market value as well as for the size of the activist investor, by adding a dummy variable that indicates whether the activist investor is included in the SharkWatch50 List (a list of the fifty largest activist

¹⁶¹ The weakness of reputational markets as a substitute mechanism is further corroborated by the use of a relatively elaborative approach to reputational channels in *Table 4*, categorizing every activist engagement with no apparent formal bargaining mechanism as affected by reputational channels. In reality these engagements could be motivated by other reasons, which will further reduce the impact of reputation.

¹⁶² An event is counted as successful when at least one of the activist's demands is accepted.

¹⁶³ The three activist engagements with ValueAct, which were settled without publicly disclosing any information, were excluded from the calculation, but even when including them in the list the success rate remains below 20%.

investors). In particular, as the result in Column 1 shows, the probability of an activist campaign successfully achieving at least one engagement outcome without any formal bargaining mechanism is 39.9% lower than it is for an activist intervention with a formal bargaining mechanism. Reputational and extra-legal forces are therefore far from a perfect substitute for formal bargaining mechanisms.

This result remains notably similar when I conduct a number of robustness checks. These checks include controlling for company performance during the three-year period that preceded the engagement (Columns 2 and 4), focusing only on unique engagements by counting multiple 13D filings submitted by different activists as one engagement if the filings were made in connection with the same event (Columns 3 and 4), and eliminating from the sample all governance and board representation demands, instead focusing solely on value/strategic demands (Column 5).¹⁶⁴

¹⁶⁴ The results for value/strategic demands engagements stayed substantially the same even when I limited the sample to unique engagements. As an additional robustness check, I re-ran the regressions using a different dependent variable, which accounts for the percentage of successful demands out of the total demands raised by the activists, and the coefficients stayed statistically significant. I also conducted the same experiment using logit instead of linear regressions, and the results remained similar.

Table 5: Results of Regressions

This Table reports coefficients of linear probability regressions where the dependent variable is “Successful Engagement,” a binary variable equal to 1 if at least one of the activist’s demands is accepted by a controlled company. Control variables for all regressions include company industry and “ln(Market Cap),” defined as the logarithm of a firm’s market capitalization when an engagement starts, and a dummy variable for the inclusion of the activist investors in the SharkWatch50 List (a list of the fifty largest activist investors). Columns 2 and 4 include a control variable for company performance (“TSR3”), defined as the total shareholder return during the three-year period that preceded the activist engagement. Columns 3 and 4 include unique engagements only by counting multiple SC 13Ds as one event if they were filed in connection with the same activist engagement. Column 5 includes only engagements where value/strategic demands were raised by the activists. All standard errors (not reported) adjust for heteroskedasticity at the firm level. Finally, *, **, and *** indicate statistical significance of the coefficients at the 90%, 95%, and 99% confidence levels, respectively.

	(1)	(2)	(3)	(4)	(5)
Activism					
without					
Formal	-0.399***	-0.383***	-0.422***	-0.461***	-0.278**
Mechanisms					
ln(Market Cap)	0.055**	0.049	0.060***	0.050	0.096***
SharkWatch50	0.030	0.060	0.111	0.122	-0.000
TSR3		-0.123		-0.161	
Industry	Y	Y	Y	Y	Y
Constant	0.574	0.608	0.566	0.681	0.554***
Observations	170	122	125	91	82
Adjusted R ²	0.0844	0.0411	0.106	0.0745	0.201

2. The Reliance of Reputation on the Formal Channels

In addition to “against all odds” engagements, I also investigated another subset of engagements that may shed more light on the operation of the reputational channels:

engagements receiving particularly strong media coverage.¹⁶⁵ When a hostile engagement becomes a high-profile one, it is more likely to attract the attention of investors and controllers' business peers. Concerns about reputational harm can then motivate a controlling shareholder to be more attentive to activists' demands in order to avoid or curtail a damaging public campaign. As a managing partner at a media-focused advisory firm industry summarized it: "[investors in controlled firms] may not be able to [influence the] vote, but they can buy big stakes in these companies and scream bloody murder if the stock declines continue. Eventually, something has got to give."¹⁶⁶

Indeed, much anecdotal evidence suggests that controllers are motivated to terminate damaging campaigns, particularly when these campaigns attract strong media coverage. Consider, for instance, the engagement with The New York Times Company. As noted earlier, the Times Company's decision to settle with the activists came after a three-month high-profile assault on the company,¹⁶⁷ and after another activist investor, Morgan Stanley Investment Management, led a vocal two-year campaign for changes in the company business,¹⁶⁸ publicly explaining that the company share price was deeply underpriced because of improper management. During 2008, the year the hedge fund launched a proxy contest against the Times Company, there were more than 300 newspaper articles that covered

¹⁶⁵ I define a campaign against a target company as one with strong media coverage if the campaign receives thirty or more references on the Factiva database during the course of the engagement.

¹⁶⁶ Nat Worden, *Controlling Media Holders Face New Scrutiny*, DOW JONES, Oct. 21, 2008, Factiva, Document DJ00000020081021e4a1000dx.

¹⁶⁷ The Factiva database shows that during the three-month period surrounding the engagement with The Times Company, there were more 200 media references to it. Headlines on Harbinger Campaign Against New York Times from Jan. 1, 2008 to Mar. 31, 2008, FACTIVA, <https://global.factiva.com> [<https://perma.cc/YPA3-KBK4>] (after logging in, click "Search"; then turn on "Query Genius" and search "Harbinger and fds=NYT and date from 20080101 to 20080331").

¹⁶⁸ See, e.g., Marr, *supra* note 9 (reporting this campaign).

it,¹⁶⁹ and the activist hedge fund kept announcing in the media that “the Times’ future depended on ‘fresh, independent leadership in the boardroom.’”¹⁷⁰

Another interesting example, the high-profile campaign against Dillard’s had more than 200 media references, most of which portrayed the controlling family in a negative light. In a public letter filed with the SEC in October 2008, the hedge funds accused management of negligence and nepotism and called several executives who were members of the controlling family “overpaid and under-qualified for the positions they hold.”¹⁷¹ One of the activist holders publicly argued that the performance of the company over the prior ten years “has been nothing short of atrocious.”¹⁷² Eventually, a settlement was reached between Dillard’s and the activist groups that received board representation, with the controlling family taking sizable cuts in compensation.¹⁷³

Activists also conducted an aggressive public campaign against Comcast. In the course of the campaign, the activist fund called for the ousting of the company controller Brian Roberts, describing his management in a *Wall Street Journal* article as a “Comcastrophe” for shareholders and claiming that it led to a decade of “zero return.”¹⁷⁴ The activist

¹⁶⁹ Headlines on Harbinger Campaign Against New York Times in 2008, FACTIVA, <https://global.factiva.com> [<https://perma.cc/YPA3-KBK4>] (after logging in, click “Search”; then turn on “Query Genius” and search “Harbinger and fds=NYT and date from 20080101 to 20081231”).

¹⁷⁰ Joshua Chaffin, *Harbinger of Conflict at NY Times*, FIN. TIMES (Mar. 1, 2008), <http://www.ft.com/cms/s/0/ea8375e4-e721-11dc-b5c3-0000779fd2ac.html#axzz43sVYRhxC> [<https://perma.cc/NZF4-6J93>].

¹⁷¹ Rachel Dodes, *Dillard’s Directors Weigh in on Attempt to Oust CEO*, DOW JONES (Nov. 5, 2008). The hedge funds also noted that the four Dillard siblings have earned more than \$16 million annually in the three years prior to the activist intervention despite a steady decline in the company’s performance and stock price. See James Covert, *Dillard’s Heated at Hedgies*, N.Y. POST (Oct. 31, 2008), <http://nypost.com/2008/10/31/dillards-heated-at-hedgies/> [<https://perma.cc/7TBG-VP8X>].

¹⁷² Dodes, *supra* note 171.

¹⁷³ See *supra* notes 105–06.

¹⁷⁴ Dionne Searcey, *Call to Oust Comcast’s Roberts by Investor Draws Mixed Reviews*, WALL. ST. J., Jan. 19, 2008, at B3.

publicly criticized Comcast for lavishing founder Ralph Roberts' estate with a multimillion-dollar benefit payable upon his death.¹⁷⁵ The company's controller succumbed to the intense public shaming and the pressures exercised by the activist fund through leading media outlets. Several weeks later, the company decided to eliminate its founder's benefits and set his annual salary at one dollar for the rest of his tenure at the company.¹⁷⁶ Additionally, it announced a quarterly dividend—its first dividend since 1999—and agreed to utilize its remaining \$6.9 billion share to repurchase authorization within a two-year period.¹⁷⁷

As the above-mentioned examples suggest, hostile engagements that attract strong media attention and could harm controllers' reputation can push those controllers to be more attentive to activists' demands. However, an examination of all high-profile engagements shows that they often reach the confrontational level of a proxy contest for board representation. Boardroom battles are interesting and they could easily make it to the front page of major financial newspapers on a constant basis. And in order to engage in a proxy contest against a controlling shareholder, or at least to threaten to launch such a contest, an activist has to rely on a formal channel of activism, such as the ability to nominate a minority director.

Overall, my examination shows that the variable of "strong media coverage"¹⁷⁸ is strongly correlated with the existence of a proxy fight for board representation. Eleven out of the sixteen controlled companies subject to high-profile activist campaigns were also targets of *actual* proxy fights,

¹⁷⁵ Vishesh Kumar & Dionne Searcey, *Comcast Drops Payout Plan for Founder Amid Criticism*, WALL ST. J., Jan. 14, 2008, at A14.

¹⁷⁶ *Id.*

¹⁷⁷ Todd Shields, *Comcast, Pressured by Holders, Sets Buyback, Dividend*, BLOOMBERG (Feb. 14, 2008), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aJr3e5rNrA.I&refer=us> [<http://perma.cc/DEV5-A4PY>].

¹⁷⁸ See *supra* note 165. For the purposes of this Article, Part II eliminated from the sample the activist engagements that relate to specific events, such as M&A transactions and lawsuits.

and one additional company was subject to a high-profile withhold campaign. Without an active boardroom fight, or at least a threat to launch one, activists are less likely to attract media attention.¹⁷⁹ Only 6% of the engagements without any formal mechanisms received strong media coverage.

In sum, while the previous Subpart showed that reputational forces cannot serve as an adequate substitute mechanism for the formal channels, this Subpart adds another layer to the analysis, suggesting that reputational forces often derive their power from the existence of formal channels that facilitate a proxy fight.¹⁸⁰ These two findings have important policy implications. They suggest that, in order to enhance activism, regulators and institutional investors should not rely solely on reputational forces to provide external monitoring.

VI. DISRUPTIVE ACTIVISM?

So far this Article shows that activist shareholders are engaging with a non-negligible number of controlled firms. But the economic justifications for activist interventions in controlled companies are not trivial and require clarification. When a company has a controlling shareholder, the basic presumption is that such controller has both the skills and incentives to properly conduct the business of the company and closely monitor its professional managers.¹⁸¹ Two main arguments stem from this basic presumption: (i) controller's

¹⁷⁹ When I tried to systemically estimate the impact of strong media coverage on the probability of an activist engagement to succeed by running a logit regression, the results (not reported) become insignificant once I control for the existence of a proxy fight and target firm size.

¹⁸⁰ See also Roy Shapira, *A Reputational Theory of Corporate Law*, 26 STAN. L. & POL'Y REV. 1 (2015) (showing that the formal process of litigation or regulatory investigations produces information, which affects parties' behavior indirectly, through shaping reputational sanctions).

¹⁸¹ See, e.g., Ronald J. Gilson & Jeffrey N. Gordon, *Doctrines and Markets: Controlling Shareholders*, 152 U. PA. L. REV. 785, 785, 792 (2003); Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 754–55 (1997).

strategic decisions are, on average, superior to those of other public shareholders (including the activists); and (ii) even when an activist brings a value-enhancing proposal, a controller has no reason to oppose it in the first place, since this controller will be the main beneficiary of any further increase in the share price (due to her equity position). Additionally, based on the first argument, one could also claim that the lower percentage of activist campaigns in controlled companies is a result of the better management of controlled companies, which makes them less attractive targets for activism than widely held companies.

However, this underlying presumption, and the arguments that stem from it, do not always hold true. Controlled companies vary in their ownership structure and many other aspects, which, in turn, impact controllers' incentives and ability to perform well.¹⁸² To begin, not all controlling shareholders hold a large stake of the controlled firm's cash flow. A significant number of controlled U.S. companies maintain a dual-class share structure,¹⁸³ which allows them to control a company while holding only a small fraction of its cash flow rights.¹⁸⁴ A large body of empirical evidence demonstrates that the use of a dual-class share reduces firm value while allowing poorly performing controllers to remain entrenched and isolated from market disciplinary forces.¹⁸⁵ Such use of this control-enhancing

¹⁸² See, e.g., Henrik Cronqvist & Rüdiger Fahlenbrach, *Large Shareholders and Corporate Policies*, 22 REV. FIN. STUD. 3941 (2009) (discussing the significant heterogeneity across blockholders).

¹⁸³ For studies discussing the prevalence of control enhancing mechanism in the United States and the costs they create, see *infra* note 185.

¹⁸⁴ See, e.g., Lucian A. Bebchuk, Reinier Kraakman & George Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, in CONCENTRATED CORPORATE OWNERSHIP 295, 298–301 (Randall K. Morck ed., 2000) (explaining the mechanism behind dual-class stock).

¹⁸⁵ See, e.g., Gompers et al., *supra* note 27; Ronald W. Masulis, Cong Wang & Fei Xie, *Agency Problems at Dual-Class Companies*, 64 J. FIN. 1697, 1722 (2009); Scott B. Smart, Ramabhadran S. Thirumalai & Chad J. Zutter, *What's in a Vote? The Short- and Long-Run Impact of Dual-Class*

device also increases controllers' tendency to extract private benefits or to pursue high-risk activities at the expense of other shareholders.¹⁸⁶

Second, not all controllers have superior business skills. A significant number of controlled U.S. companies are family firms managed by heirs of founders,¹⁸⁷ and economic literature has firmly established that firms run by decedents of founders underperform firms managed by hired CEOs, as heirs of the original founders often lack the business expertise, talent, or motivation of the founders.¹⁸⁸

Third, even if controlling shareholders maintain a large economic interest and possess superior skills, they may still have interests of their own that do not align with the interests of other investors, such as entrenchment, capital preservation, or entry into new businesses about which the

Equity on IPO Firm Values, 45 J. ACCOUNT. ECON. 94 (2008). See also INVESTOR RESPONSIBILITY RESEARCH CENTER INSTITUTE, CONTROLLED COMPANIES IN THE STANDARD & POOR'S 1500: A TEN-YEAR PERFORMANCE AND RISK REVIEW (Oct. 2012), <http://irrcinstitute.org/pdf/FINAL-Controlled-Company-ISS-Report.pdf> [<http://perma.cc/H9P7-4JC6>] (finding that controlled companies with multi-class stock structures underperform widely held companies and controlled companies with single-class structures over three-, five-, and ten-year time periods); Renée Adams & Daniel Ferreira, *One Share-One Vote: The Empirical Evidence*, 12 REV. FIN. 51 (2008) (conducting an extensive survey of the economic literature on dual-class firms and concluding that the deviations from one share, one vote affect the value of outside equity negatively).

¹⁸⁶ See, e.g., Bebchuk et al., *supra* note 184 (presenting a model that proves this argument). For empirical support see, e.g., Gompers et al., *supra* note 185; Masulis et al., *supra* note 185.

¹⁸⁷ See, e.g., Anderson et al., *supra* note 47, at 207 (showing that, in 2000, of the largest industrial U.S. firms, "founder-controlled firms constitute 22.3% and heir-controlled firms . . . [comprise] 25.3%, with average equity stakes of approximately 18% and 22%, respectively").

¹⁸⁸ See, e.g., Ronald C. Anderson & David M. Reeb, *Founding-Family Ownership and Firm Performance: Evidence from the S&P 500*, 58 J. FIN. 1301, 1316–17, 1321 (2003); Morten Bennesen, Kasper Meisner Nielsen, Francisco Perez-Gonzalez & Daniel Wolfenzon, *Inside the Family Firm: The Role of Families in Succession Decisions and Performance*, 122 Q.J. ECON. 647, 669–70, 684 (2007); Belen Villalonga & Raphael Amit, *How Do Family Ownership, Control and Management Affect Firm Value?*, 80 J. FIN. ECON. 385, 399–400 (2006).

controllers know little but which are personally alluring.¹⁸⁹ Controllers can also engage in various forms of self-dealing transactions, commonly referred to in the literature as “tunneling,” which divert value from the minority shareholders to the controllers.¹⁹⁰

Finally, there are also non-pecuniary considerations, such as pride, envy, or animosity, which could filter into controllers’ decision to reject activists’ demands.¹⁹¹ Therefore, there is no reason to believe a priori that controllers’ decisions to oppose activists’ demands always benefit minority shareholders.

To further explore this issue, I examined the different demands raised by activists in the course of their engagements with the sampled controlled companies and divided them into three main groups: demands related to the tension between controllers and minority shareholders,

¹⁸⁹ See Anderson & Reeb, *supra* note 188, at 1302–03 (“[F]ounding families have concerns and interests of their own, such as stability and capital preservation that may not align with the interests of other investors or the firm.”); Alessio M. Paces, *Control Matters: Law and Economics of Private Benefits of Control* 9 (European Corp. Governance Inst. Law Working Paper Series, Paper No. 131/2009, 2009), <http://ssrn.com/abstract=1448164> [<http://perma.cc/W69Y-RCWH>] (noting that protecting controller’s psychic private benefits can harm other shareholders by preventing efficient changes in control in the future); Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1667 (2006) (mentioning the transformation of certain businesses associated with the Bronfman family from liquor and oil to entertainment as an example of a business decision that could be motivated by controllers’ desire to increase their consumption of non-pecuniary private benefits rather than firm value).

¹⁹⁰ See Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Tunneling*, 90 AM. ECON. REV. 22 (2000). For discussion and anecdotal examples of tunneling in the United States, see Vladimir Atanasov, Bernard Black & Conrad S. Ciccotello, *Law and Tunneling*, 37 IOWA J. CORP. L. 1 (2011).

¹⁹¹ See Ehud Kamar, *The Story of Paramount Communications v. QVC Network: Everything Is Personal*, in CORPORATE LAW STORIES 293, 321 (J. Mark Ramseyer ed., 2009).

board representation demands, and value/strategic demands. The results are summarized in *Table 6*.

(i) *Demands related to the tension between controllers and minority shareholders*: The first category includes demands to enhance governance standards, to add independent directors, and to improve compensation practices. This category also encompasses demands to increase share price in going-private transactions or activists' demands to block a merger at a depressed offering price. Since those demands relate to the basic agency problem between controlling shareholders and minority shareholders,¹⁹² it is likely that controllers' decisions to oppose such demands do not align with the interests of all other minority shareholders (and not just the activists). Indeed, as shown in Part V.B, in the majority of the M&A-related engagements (58%), activist pressure pushes controllers to sweeten the offering price or to modify the transaction terms in a way that benefits *all* minority shareholders.¹⁹³

(ii) *Demands related to board representation*: The demand for a seat on the board may also be beneficial to other minority shareholders, as it could enhance the external monitoring of the controller or managers nominated by the controller. As noted earlier, an outside director who is truly independent of the controller is in a better position to spot conflict of interest transactions, bring additional information and perspective to the boardroom, and promote greater transparency and deliberation.¹⁹⁴ Also, if shareholders unaffiliated with the controller oppose the nomination of the activist's representative to the board, they can simply vote against it and reduce her chances of being elected. Evidence

¹⁹² See, e.g., Shleifer & Vishny, *supra* note 181, at 740–44 (1997); Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV. 1263, 1281 (2008).

¹⁹³ Note that in an additional 34% of the M&A-related engagements the activists managed to block a transaction at what they perceived as an undervalued price. While blocking transactions may benefit minority shareholders (if the offering price is truly depressed), it is not necessarily always the case, because the activists could also block efficient transactions.

¹⁹⁴ See *supra* notes 95–97 and accompanying text.

shows, however, that when an activist event becomes a proxy fight, and public shareholders have to choose between controllers' nominees and activists' nominees, they tend to support the board nominees of the activists.¹⁹⁵

(iii) *Value-enhancing/strategic demands*: The last category includes value-enhancing/strategic demands, such as demands to divest the company's assets, to return cash to shareholders, to review strategic alternatives, and so on. It is difficult to know a priori whether this type of proposal benefits minority shareholders as a whole, and not just the activists. However, the average total shareholder return during the three-year period that preceded the activist intervention of all the companies that were subject to any strategic demands (-9.8%) shows that they generally tend to underperform.

In addition, a review of the ownership structure, control mechanism, and other characteristics of the twenty-four controlled companies that were subject to core strategic demands¹⁹⁶ further suggest that those companies, at least on their face, meet the profile of companies that tend to underperform. For instance, 75% of these companies have a dual-class structure with an extreme divergence between controllers' ownership rights and voting rights. Additionally, all of these companies are mature, where the controllers (usually family members) have been entrenched for an extended period. In fact, the "youngest" company on this list was established in 1989, and the average "age" of the

¹⁹⁵ The dissident nominees were elected in the vast majority of the proxy fights in my sample, including in the following cases: Media General, Inc. (2007); Morgans Hotel (2013); National Interstate Corporation (2013); Private Media Group (2011); Telephone and Data Systems, Inc. (1997); The Quigley Corporation (2009); and Whitney Information Network, Inc. (2009). Even when the activist failed to nominate its representatives to the board, it is often the case that such representatives received the majority support of shareholders unaffiliated with the controller. See Barnes and Noble (2009) and the withhold campaign against Telephone and Data Systems, Inc. (2008).

¹⁹⁶ Core strategic demands are demands to divest the company's assets, to return cash to shareholders, or to initiate a capital restructuring.

companies studied here is more than sixty years old. In more than half of them, the heirs of the founders either took over or were involved in the management of the controlled firms. As noted earlier, there is a large body of economic literature documenting mediocre performance of mature dual-class firms or family firms controlled by heirs of the founders,¹⁹⁷ and activists' decisions to focus on this segment of controlled companies (rather than companies controlled by private equity firms, venture capital firms, or "younger" dual-class firms) suggest that the value/strategic demands they raise could benefit other minority investors. This data is also consistent with general evidence that hedge fund activists tend to target underperforming companies.¹⁹⁸

¹⁹⁷ See *supra* note 188.

¹⁹⁸ See *supra* notes 38–39.

Table 6: Activists' Demands

Activists' Demands ¹⁹⁹	Yes	No	Total
1. Demands related to the tension between controllers/minority holders			
i. Governance Demands:			
Add Independent Directors	3	9	12
Compensation Related Enhancements	4	8	12
Other Governance Enhancements	12	29	41
Remove Directors or Officers	4	6	10
Remove Takeover Defenses	3	14	17
ii. M&A Related Demands:			
Block Merger/Agitate for Higher Price	15	2	17
Potential Acquisition (Friendly and Unfriendly)	1	4	5
2. Representation Demands:			
Board Seats	27	25	52
3. Value/Strategic Demands:			
Breakup Company, Divest Assets/Divisions	4	9	13
Other Capital Structure Related, Increase Leverage, etc.	3	15	18
Return Cash via Dividends/Buybacks	9	15	24
Review Strategic Alternatives	9	21	30
Seek Sale/Merger/Liquidation	3	20	23
Separate Real Estate/Create REIT	0	3	3
Total:	97	181	278

Finally, I have also explored the hypothesis that activist investors may be willing to engage with controlled companies simply to extract quick private benefits from the controllers by forcing them to buy back the activists' stake. Certain activist campaigns—even those that are unlikely to succeed—may intentionally disrupt the activity of a controlled company and publicly challenge the way a controller manages the company by engaging in what could

¹⁹⁹ “Yes”/“No” indicate whether an activist's demand was accepted/rejected, respectively.

be viewed as “disruptive activism.” Since the controlled company has to bear the legal, reputational, and other costs associated with conducting a proxy fight or defending the controller’s position, the controlled company may simply opt to save those costs and terminate any disruptive activity by buying out the activist shareholder at a premium. In fact, this type of buy-out is somewhat similar to the much-maligned 1980s tactic of “greenmail.”²⁰⁰ While a buy-out of an activist stake may not always benefit other non-activist shareholders, and sometimes even comes at their expense, it can also provide activists with additional ex ante incentives to launch a campaign against controlled companies.²⁰¹

The empirical evidence provides little support for the disruptive activism story. A search on the SharkWatch database yields only a handful of examples of activist interventions with controlled companies that resulted in the repurchase of the activist stake by the target company.²⁰²

²⁰⁰ “Greenmail” has generally been defined as the practice of purchasing enough shares in a company to threaten a takeover, and then using that leverage to pressure the target company to buy those shares back at a premium in order to abandon the takeover. *See, e.g.*, Jonathan R. Macey & Fred S. McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 *YALE L.J.* 13, 13–15 (1985).

²⁰¹ It is important to emphasize, however, that activists are unlikely to generate high abnormal returns through disruptive activism if ex ante a campaign has no likelihood of success. If the main channels of activism discussed in Parts IV and V are not effective enough to facilitate engagements with controlled companies, controllers may simply ignore the activists’ demands without providing them any side payments.

²⁰² One example is the engagement with Tix Corporation, a controlled company whose management held approximately 37% of the firm voting rights. In June 2011, after an activist player announced its intention to nominate a slate of directors at the upcoming annual meeting, the company accused the activist of trying to “extract greenmail” from it by forcing the company to buy the activist’s stake. In July 2011, the parties reached a settlement pursuant to which the company agreed to add three activist nominees to the Board, and in December 2013, the company agreed to repurchase the activist stake. *See* Press Release, Tix Corporation (Dec. 24, 2013), <http://www.marketwired.com/press-release/tix-corporation-announces-stock-repurchase-and-director-resignations-otcqx-tixc-1865252.htm> [<http://perma.cc/DF8L-DDHH>]; Press Release, Tix Corporation, Tix Corporation Announces Stock Repurchase and Director

Disruptive activism seems to have very little power, if any, to explain activism in controlled companies.²⁰³

VII. POLICY IMPLICATIONS

The findings presented in this Article raise a few important implications for policy makers and institutional investors. To start, it shows that controlled companies are more insulated from activism than widely held companies (although they are not fully immune to it),²⁰⁴ and this relative insulation could affect entrepreneurs' decision-making at the IPO stage. For instance, it could increase the incentives for entrepreneurs to retain control when they take their firm public in order to better shield themselves from the market for corporate influence.²⁰⁵ Indeed, recent evidence shows that there is a general upward trend in the adoption of dual-class stock as a control enhancing mechanism.²⁰⁶ Once a company goes public with a dual-class structure, its controller has a tendency to retain this structure and remain entrenched for a long period of time,²⁰⁷ even if she is no longer best situated to manage the company.²⁰⁸

Resignations (June 30, 2011), <http://www.prnewswire.com/news-releases/tix-corporation-sends-letter-to-stockholders-124783023.html> [<http://perma.cc/BCM6-RY28>].

²⁰³ For an empirical study supporting this view, see Belcredi & Enriques, *supra* note 64, at 31–32 (researching shareholder activism in Italy and finding no sufficient evidence to support the “dark side” view of activism).

²⁰⁴ See *supra* Part III.A.

²⁰⁵ For a discussion about the increasing use of dual-class stock, see *infra* note 224 and accompanying text.

²⁰⁶ See Steven Davidoff Solomon, *Shareholders Vote with their Dollars to Have Less of a Say*, N.Y. TIMES: DEALBOOK (Nov. 4, 2015), http://www.nytimes.com/2015/11/05/business/dealbook/shareholders-vote-with-their-dollars-to-have-less-of-a-say.html?_r=0 [<https://perma.cc/8RDT-6JLH>] (“More than 13.5 percent of the 133 companies listing shares on United States exchanges in 2015 have set up a dual-class structure, according to the data provider Dealogic. That compares with 12 percent last year and just 1 percent in 2005.”).

²⁰⁷ For instance, data collected from SharkRepellent shows that controllers systematically reject shareholder proposals to dismantle dual-

Furthermore, when activists do engage with controlled companies, a large number of these engagements are facilitated by certain legal arrangements—such as the ability to elect minority directors or to veto conflicted transactions—which augment activists’ leverage vis-à-vis the controllers. These formal bargaining mechanisms substantially increase the likelihood that activists’ voices will be heard. In their absence, controllers are likely to be insulated from hedge fund activism, and even when an activist engagement occurs, controllers tend to ignore activists’ concerns.²⁰⁹ However, issuers have few incentives to voluntarily adopt legal arrangements that empower activists, such as the right to elect minority directors. While a subset of dual-class firms went public with a capital structure allowing shareholders not affiliated with the controller to elect minority directors, this arrangement was most common in mature dual-class firms that were *required* to do so in order to comply with a previous policy of the AMEX.²¹⁰ Current listing requirements of the major U.S. stock exchanges no longer impose any restrictions on new issuances of unequal voting stock,²¹¹ and

class capital structure. Between 2005 and 2014, investors voted on fifty shareholder proposals to eliminate dual-class structures at twenty-two Russell 3000 companies, with none receiving majority support, mainly because the controlling shareholders voted against them (after logging in to SharkRepellent, click the “Proxy Tab” and search based on “Proposal: Eliminate Dual-Class Stock”, “Index: Russell 1000, Russell 2000”, and “Proxy Proposal brought by shareholders”).

²⁰⁸ For a comprehensive discussion of this point, see Lucian Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-class Stock* (Nov. 2015) (unpublished manuscript) (on file with author).

²⁰⁹ Within the group of controlled companies that were subject to activism, only 21% of the activist events were enacted when the activists lacked any formal bargaining tools, and the success rate of these engagements was low (11%).

²¹⁰ See *supra* notes 108–14.

²¹¹ See, e.g., NYSE, Listed Company Manual § 313.00 (2015), http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?searched=1&selectednode=chp_1_4_13&CiRestriction=313&manual=%2F%2Fsection%2F%2Fsections%2F [https://perma.cc/DQK5-VYDN]; NASDAQ Stock Market, Inc., NASDAQ Stock Market Rules § 5640 (2015), http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1

controlled companies that went public in the past decade (when hedge fund activism gained steam) were unlikely to voluntarily adopt such an arrangement²¹² and subject themselves to the disciplinary power of activist holders.

Finally, an analysis of “against all odds” engagements and engagements that receive strong public attention shows that controllers’ reputational concerns also play a role in encouraging activism and disciplining controllers, but mostly when such forces serve as a *complementary* mechanism, operating in conjunction with other formal bargaining mechanisms. When activists have no other apparent formal bargaining mechanisms, reputational markets alone have a mild disciplinary effect, at best, on controlling shareholders, and they are far from a perfect substitute for formal bargaining mechanisms.²¹³

Understanding the mechanisms that facilitate activism in controlled companies and their limits is important, since a significant number of controlled companies maintain a dual-class share structure or are heir-controlled firms, and empirical evidence shows that these types of firms tend to underperform widely held companies.²¹⁴ Therefore, regulators and institutional investors, who view activism as a value-enhancing development,²¹⁵ which could curb controllers’ opportunism and from which other public

_1_1_1&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F
[<https://perma.cc/GMC5-TJU9>].

²¹² For instance, of all the dual-class firms in the Sample of Publicly-disclosed Engagements that provide public shareholders with the ability to elect minority directors (eighteen companies in total), only one company was established after 2005. Similarly, I found that only four out of all the Delaware dual-class firms that had proportional voting for directors as of 2012 (twenty-six companies) went public after 2005.

²¹³ See *supra* Part V.B.

²¹⁴ See *supra* notes 185–88.

²¹⁵ As explained earlier, recent empirical studies, as well as the data presented in this Article, support the value-enhancing view of activist engagements. See *supra* notes 38–39 (discussing the positive short- and long-term effects of hedge fund activism) and the discussion in Part VI (analyzing the different demands raised by activist investors and showing how they could benefit other minority shareholders).

shareholders might benefit, should not rely on reputation markets as the sole facilitators of activist engagements. Nor should they rely on issuers to adopt arrangements that facilitate activism, as issuers have no incentive to voluntarily subject themselves to the disciplinary power of activist holders. Instead, they are urged to adopt arrangements that will further encourage activism in controlled companies, and the most efficient way to accomplish this goal would be to grant shareholders unaffiliated with the controllers the right to elect a minority slate of directors, or to block the nomination of certain directors nominated by the controlling shareholders.

As Part V.A shows, this mechanism increases activists' bargaining power vis-à-vis the controller (even if the majority of the board is filled with directors related to the controller), and may cause controlling shareholders to become more attentive to shareholders' concerns. Such a mechanism provides public shareholders in controlled firms with powers that are somewhat similar to those that shareholders of widely held firms have. It gives hedge funds the ability to threaten a proxy fight and to nominate a number of directors to the board, and it gives institutional holders the ability to vote against the election of the controller's director nominees if the controller ignores well-supported shareholder proposals.

A few jurisdictions have already implemented somewhat similar solutions. Italy's *voto di lista* rule adopted in 2007 requires, under certain conditions, both the board of directors and the board of auditors to have at least one member elected by minority shareholders.²¹⁶ Evidence shows that hedge funds invest in Italian companies with

²¹⁶ Under Italian law, the shareholding required for submission of a minority slate for the election of the board of directors varies from 0.5% to 4.5% according to the size of the company's market capitalization. For additional discussion regarding this rule, see Matteo Erede, Andrea di Segni & John Wilcox, *Italy's 'Vote by Slate' – an Innovative Method to Elect Minority Directors*, INT'L CORP. GOVERNANCE NETWORK 54–55 (2009), <http://www.sodali.com/static/allegati/C-0016.pdf> [<http://perma.cc/W4UM-HEX6>].

concentrated ownership when they are able to take advantage of this legal tool that allows minority shareholders to elect their representative to the board of directors.²¹⁷ In Sweden, a firm's three to five largest shareholders can form a nominations committee for board members, and any shareholder can nominate board candidates prior to the annual meeting.²¹⁸ When the company has a dominant shareholder, at least one member of the committee must be independent of the company's largest shareholder.²¹⁹ Marco Becht et al. show that when activists join the nominations committee, they succeed in appointing directors sympathetic to their goals who are able to influence the engagement outcomes.²²⁰

In fact, the proposed solution is not new even in the United States. The Wang formula—a statement of policy implemented by the AMEX from 1976 through the middle of the 1980s (the time when major U.S. exchanges relaxed their restrictions on the use of dual-class stock)—required dual-class firms that went public during that period to entitle public holders with the right to elect 25% of the board of directors.²²¹ Evidence presented in this Article shows that such special governance structure has become an important channel of activism.²²²

Though a detailed analysis of all the costs and benefits of the proposal to entitle public shareholders with the right to nominate minority directors is beyond the scope of this

²¹⁷ See Erede, *supra* note 65, at 359; Belcredi & Enriques, *supra* note 64.

²¹⁸ Becht et al., *supra* note 60, at 15–16. See also Rolf Skog & Erik Sjöman, *Corporate Governance in Sweden*, in THE NORDIC CORPORATE GOVERNANCE MODEL 247, 260–62 (Per Lekvall ed., 2014); Rolf H. Carlsson, *Swedish Corporate Governance and Value Creation: Owners Still in the Driver's Seat*, 15 CORP. GOVERNANCE 1038, 1049–50 (2007).

²¹⁹ Skog & Sjöman, *supra* note 218, at 261. Also, when the dominant shareholder owns less than 50% of the voting power, such shareholder has to cooperate with other public shareholders in order to secure a majority vote at the annual general meeting.

²²⁰ Becht et al., *supra* note 60, at 15–16.

²²¹ See *supra* notes 108–14.

²²² See *supra* notes 114–15.

Article, it certainly merits additional exploration. Recently, Lucian Bebchuk and Assaf Hamdani called for granting public investors certain say in the elections and terminations of some independent directors in order to make those directors effective monitors of controlling shareholders. They provided a comprehensive analysis of such solution.²²³ This Article highlights another important aspect of any proposal to empower public shareholders to appoint minority directors, showing that such right plays a crucial role in encouraging activism in controlled companies and reducing the insulation of controllers from external monitoring.

VIII. CONCLUSION

“I have seen the future and it is very much like the present, only longer.”

—Kehlog Albran, *The Profit*

If one had to predict the future of U.S. corporate governance, then based on this quote, the safest prediction would be that the two major governance developments in recent years—the rise in shareholder activism and the increased use of concentrated ownership—will continue to gain importance. Activists are here to stay as long as agency problems exist, and as long as the corporate law regime does not impede their ability to initiate governance and strategic changes in underperforming firms. Similarly, certain entrepreneurs are expected to continue going public while retaining control over their firms, often through the use of dual-class structures (unless such a structure is limited by regulators). These two major governance developments do not progress along parallel lines. It is the first development (the rise in activism) that could further enhance the second development (increased concentrated ownership) by fortifying the incentives of entrepreneurs to retain control in order to insulate themselves from the market for corporate influence. Indeed, recent evidence shows that there is a

²²³ Lucian A. Bebchuk & Assaf Hamdani, *Making Independent Directors Work*, 164 U. PA. L. REV. (forthcoming Mar. 2016).

general upward trend in the adoption of dual-class stock, and this structure is becoming “the current flavor.”²²⁴

This Article is the first endeavor to explore the interaction between these two major governance developments—that is, how shareholder activism impacts controlled U.S. companies. Somewhat counter-intuitively, this Article documents a non-negligible number of shareholder engagements with controlled firms, and it shows that activists’ bargaining power vis-à-vis controllers is not always as limited as initially predicted. It also highlights a few motivating forces that facilitate activism against controlled companies, including the right to nominate and elect minority directors, the right to veto going-private transactions, and the use of litigation as a means to put pressure on controllers. Finally, this Article also provides some anecdotal evidence showing that controllers’ reputational concerns also play a role in encouraging activism and disciplining controllers when these forces operate in conjunction with other legal and formal bargaining mechanisms.

However, regulators and institutional investors who view activism as an important disciplinary mechanism should not rely solely on the current regulatory framework or reputation markets to continue facilitating this activity. The increasing use of dual-class structures, which allows issuers to maintain full control over their companies for indefinite periods of time, along with issuers’ recent tendency not to adopt arrangements that provide public shareholders with the right to nominate and elect minority directors substantially weaken the most common channel of

²²⁴ See Green & Levy, *supra* note 48. A senior practitioner who has been involved in more than 100 IPOs has stated: “This [dual-class structure] is the current flavor Five years ago, people weren’t asking about them. Now everyone is asking about it right away.” *Id.* Another senior partner, who helped Facebook set up its initial corporate-governance structure, said: “People look at Facebook and see what they have done It’s become a much more common thing to implement dual-class capital structures in Silicon Valley companies.” *Id.* See also *supra* note 206.

activism.²²⁵ Moreover, as shown in this Article, when activists have no other apparent formal bargaining mechanisms, controllers are more likely to ignore their demands, and reputational markets alone have a mild disciplinary effect, at best.

For these reasons, regulators and institutional investors, who are interested in encouraging activism in controlled companies, are urged to require issuers to grant shareholders unaffiliated with the controllers the right to elect minority directors. This solution, which needs to be further fleshed out, may not solve all the governance problems in controlled companies, but it certainly has the potential to make controlling shareholders more accountable to other public shareholders by creating an effective platform for activist involvement.

²²⁵ *Supra* note 213.