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THEORIES AND SOLUTIONS ON WOLF PACK ACTIVISM

*Kimberly Goldman**

INTRODUCTION

In recent years, the costs of shareholder activism have declined.[1] This is partly a result of the new power of proxy advisors, to whom many institutional investors have outsourced their proxy voting decisions.[2] Additionally, changes in SEC rules have resulted in shareholder activism decline, and, in turn, have led to a tactic that activist hedge funds have developed to gain high profits with extremely low risk.[3] This tactic, "wolf pack" activism, occurs when activists work in unison to gain control of corporate boards.[4] Effectively, wolf pack activism enables activists to escape corporate defenses, such as the poison pill.[5] These results have led to controversial discussions about whether it is better to endorse or to pre-

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1. John C. Coffee, Jr. & Darius Palia, *The Wolf at The Door: The Impact of Hedge Fund Activism on Corporate Governance*, 1 ANNALS OF CORP. GOVERNANCE 1, 4 (2016).

2. *Id.*

3. *Id.*

4. Carmen X.W. Lu, *Unpacking Wolf Packs*, 125 YALE L.J. 773, 773 (2016).

5. Coffee & Palia, *supra* note 1.

vent wolf pack activism.[6] The practice, moreover, has surged in recent years.[7] In fact, with "activist hedge funds . . . multiplying like algae in a petri dish,"[8] wolf pack activism's growing popularity merits attention due to its large impact on corporate governance.

Section I will describe the key players involved in wolf pack activism and their conflicting motives, including both the members of wolf packs and those affected by them. Given that not all shareholders have common interests,[9] this will include an analysis of the motives of various types of shareholders and an analysis of how these diverse motives may affect the wealth sustainability of companies. Section II will explain the phenomenon of wolf packs in corporate governance by describing the circumstances that lead to their formation and the various regulations (or lack thereof) pertaining to them. Section III will describe divergent theories about shareholder value and how these theories impact views about wolf packs in corporate governance. Section IV will analyze the theories, taking into account the motives of the various players described in Section I. This analysis will include a discussion of which players are more likely to adopt each theory. Lastly, Section V will discuss potential reforms in light of the best theory on the impact of wolf pack activism.

I. The Players Involved

A. *The Shareholder Divide: A Divergence of Interests*

Shareholders have an increasingly strong voice in corporate governance with the emergence of wolf packs.[10] This statement is oversimplified, however, as it implies that all shareholders have a common interest. In reality, "shareholders are . . . a fragmented and fractured group with disparate interests."[11] The truth is that *some* shareholders have increasingly strong voices with the emergence of wolf packs and that this may come at the expense of other passive shareholders.

One immediate problem is that the term "shareholder" includes not only hedge fund activists who care about short-term benefits but also owners who care primarily about the long-term benefits of the company in

6. *Id.*

7. Lu, *supra* note 4.

8. J.C. Coffee, Jr., *Activism: A Guide for the Perplexed,* CLS BLUE SKY BLOG (January 25, 2016), http://clsbluesky.law.columbia.edu/2016/01/25/hedge-fund-activism-a-guide-for-the-perplexed/.

9. Martin Lipton, *Will a New Paradigm for Corporate Governance Bring Peace?*, Harvard Law School Forum on Corporate Governance and Financial Regulation (October 5, 2015), https://corpgov.law.harvard.edu/2015/10/05/will-a-new-paradigm-for-corporate-governance-bring-peace/.

10. *See generally* Lu, *supra* note 4.

11. Jennifer Hill, *The Shifting Balance of Power Between Shareholders and the Board: News Corp's Exodus to Delaware and Other Antipodean Tales* at 21 (Vanderbilt Law and Economics Research Paper No. 08-06) (January 1, 2008), https://ssrn.com/abstract=1086477.

which they hold stock.[12] Wolf packs are composed mainly of the former type of shareholder, not the latter.[13] As shareholders who are motivated primarily by short-term stock increases gain a stronger voice, their actions may have a powerful impact on other shareholders, the board, and the wealth sustainability of companies.[14]

The composition of shareholders in public companies has changed significantly since the 1960's when Congress enacted the Williams Act.[15] At that time, around 80% of shares in US corporations were held by widely dispersed, individual shareholders who did not have the resources or the incentives to remain well informed.[16] By contrast, in the modern corporate governance climate, most shares are owned by institutional investors (such as hedge funds) who *do* have the resources and the incentives to remain active participants in shareholder democracy.[17] As stated earlier, wolf packs are typically composed of this category of shareholder.[18] However, wolf packs may also be composed of other active shareholders who are *not* activist hedge funds, but who seek to bring about positive changes in corporations in order to create value for both themselves and passive shareholders.[19]

Before opining on whether the laws which affect wolf packs should be changed, it is necessary to examine the interests of the main players involved, or those who will be affected by any proposed reform. According to the Chief Justice of the Delaware Supreme Court, Leo Strine, Jr., a proper understanding of the interests of those involved in wolf packs is necessary before we can consider how our corporate governance system should regulate activist hedge funds.[20] He explains that this focus on the various types of shareholders allows us to "humanize our lens and remind ourselves of the realities of who living, breathing investors are, and the ways in which they are allowed to participate in the system, and the effect these realities have on what corporate governance system would be best for them."[21]

12. *See* Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and our Strange Corporate Governance System*, 126 YALE L. J. 1870, 1871–72 (2017).

13. *Id.* at 1872.

14. *See generally* Lipton, *supra* note 9.

15. Andrew E. Nagel et al., *The Williams Act: A Truly "Modern" Assessment,* HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Oct. 22, 2011), http://corpgov.law.harvard.edu/wp-content/uploads/2011/10/The-Williams-Act-A-Truly-Modern-Assessment.pdf.

16. *Id.*

17. *See id.*

18. Strine, *supra* note 12.

19. *See* Nagel et al., *supra* note 15.

20. Strine, *supra* note 12, at 1876.

21. *Id*. at 1870.

For example, shareholders who are not members of hedge funds may be investing in companies to save their money for long-term future use, for example, to pay for college or for retirement.[22] For most Americans, once funds are invested in a 401(k) plan, the funds are out of their reach until they reach age fifty-nine and a half.[23] While that is just one example of a plan that focuses workers' reliance on sustainable wealth creation, it illustrates the fact that most workers will not benefit from temporary stock bubbles or unsustainable strategies (arguably including wolf pack activism) without a long-term benefit.[24]

On the other hand, activist hedge funds are, by definition, much more involved than the typical shareholder.[25] They are focused on generating profit by implementing major changes in public companies, including: changes to investment strategies, financing structure, or the number of employees in a company.[26] In order to effect these changes, activist investors often purchase a large stake in a public company and then lobby management to implement changes that the activists believe will increase shareholder value.[27] They may also effect change by using a proxy contest to win support of a company's other shareholders.[28]

B. *Shareholders and the Board: Power Dynamics*

By allowing shareholders to privately lobby other shareholders, the SEC has made it possible for the outcome of matters presented to a shareholder vote to be decided privately, out of view of both the corporation and the typical, passive shareholders who are mostly concerned with long-term growth.[29] There is widespread concern that activist hedge funds increasingly exploit the reporting rules promulgated by the SEC to the disadvantage of ordinary investors.[30]

According to a Wachtell, Lipton, Rosen & Katz founding partner and corporate governance innovator, Martin Lipton, "[o]ur corporate governance system is structured similarly to our national government" in the sense that "[u]ltimate power rests with the shareholders who cannot act

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22. *Id.*

23. *Id.* at 1878*; see also* I.R.C. § 72(t)(2)(A)(i) (2012).

24. Strine, *supra* note 12, at 1878.

25. *See generally* Anita Anand & Andrew Mihalik*, Coordination and Monitoring in Changes of Control: The Controversial Role of "Wolf Packs" in Capital Markets* (Osgoode Hall Law Sch. Legal Studies Research Paper Series, Research Paper No. 34, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2906755.

26. Lu, *supra* note 4.

27. *Id.*

28. *Id.*

29. Lipton, *supra* note 9.

30. See Theodore Mirvis, *Activist Abuses Require SEC Action on Section 13(d) Reporting*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Mar. 31, 2014), https://corpgov.law.harvard.edu/2014/03/31/activist-abuses-require-sec-action-on-section-13d-reporting/.

directly but only through their elected representatives—the directors."[31] Directors are elected annually, and shareholders can change the composition of the board through various mechanisms provided by state and federal law.[32] When shareholders are able to circumvent these mechanisms intended to restrain them, power inevitably shifts from the board, as representative intermediaries, directly to the shareholders. This is concerning, as "shareholders are likely to abuse participatory powers, engage in opportunism, [and] prefer their private sectional interests to those of shareholders generally."[33] If this assumption is true, one must not only worry about protecting companies from shareholders or shareholders from companies, but also about protecting shareholders from each other.[34]

Therefore, the traditional framework for thinking about shareholders and the board is flawed in primarily emphasizing the divide between shareholders and corporations. Given the current state of the law in the United States and considering the notion that wolf packs shift the balance of power between corporate boards and shareholders, it may make more sense to consider three primary groups: shareholders motivated by short-term interests, shareholders motivated by long-term interests, and board members (who may be motivated by either of these interests).

II. Definition and Circumstances Surrounding Formation

Shareholders with parallel interests, acting together to effect change in a given corporation without disclosing their collective interests, have come to be known as "wolf packs."[35] As stated earlier, these packs are typically composed of activist hedge funds.[36] Additionally, these activist hedge funds usually congregate around a target company, where one fund acts as a "lead" activist, while the others act as peripheral activists.[37]

Activist investors work together because their combined presence in a company's stock increases the campaign's likelihood of success.[38] When the group obtains more than five percent of collective ownership in a company, the lead activist (or "alpha wolf")[39] is required to comply with dis-

31. Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 Bus. Law. 101, 105 (1979).

32. *Id.*

33. Hill, *supra* note 11, at 21.

34. *Id.*

35. Anand & Mihalik, *supra* note 25.

36. *Id.*

37. Brav, Dasgupta, & Mathews, *Wolf Pack Activism*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Feb. 09, 2015), https://corpgov.law.harvard.edu/2015/02/09/wolf-pack-activism/.

38. Beth Flaming, *Best Defense Against 'Wolf Pack' Investors Is To Anticipate Their Attack*, FORBES (Nov. 3, 2015), https://www.forbes.com/sites/danielfisher/2015/11/03/best-defense-against-wolf-pack-investors-is-to-anticipate-their-attack/#67f9f94117e1.

39. Strine, *supra* note 12, at 1896.

closure rules promulgated by the SEC.[40] Under Schedule 13D, commonly known as a "beneficial ownership report," "when a person or group of persons acquires beneficial ownership of more than five percent of a voting class of a company's equity securities registered under Section 12 of the Securities Exchange Act of 1934, they are required to file a Schedule 13D with the SEC."[41] Because the public announcement of the activist's campaign usually leads to a positive stock return, the lead activist, who eventually makes the 13D filing, recruits other investors to join the campaign *before* the 13D filing goes public.[42] The activist then uses the expected jump in stock price to compensate the other investors for their support.[43]

As an example of how this works, the activist (which could be a company) will first make a purchase in a target company and encourage other activist investors to follow their lead by also purchasing stock in that company.[44] When the lead activist induces other investors to acquire shares of the target, it is able to accumulate a larger percentage of de facto ownership before triggering regulation thresholds.[45] In other words, investors accumulate stakes in the target firms before the activists' campaigns are publicly disclosed.[46]

This relationship is mutually beneficial for the activists: "[T]he strength of the pack is the wolf, and the strength of the wolf is the pack."[47] This advantage increases the chances of a successful campaign.[48] Compared with other activist investors, the market responds more enthusiastically to wolf packs with an average of fourteen percent in abnormal returns on the date of its public appearance.[49] Additionally, the presence of a wolf pack is associated with a statistically significant eight percent increase in buy and hold abnormal (raw) returns calculated over the duration of the campaigns.[50]

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40. Schedule 13D*,* SEC (Dec 5., 2012), https://www.sec.gov/fast-answers/answerssched13htm.html.

41. *Id.*

42. Yu Ting Forester Wong, *Wolves at the Door: A Closer Look at Hedge Fund Activism*, at 18 (Columbia Business School Research Paper No. 16-11., 2016), https://ssrn.com/abstract=2721413.

43. *See id.* at 4.

44. Lu, *supra* note 4.

45. Wong, *supra* note 42.

46. *Id.*

47. RUDYARD KIPLING, *The Law of the Jungle*, *in* THE JUNGLE BOOK (1894), http://www.kiplingsociety.co.uk/poems_lawofjungle.htm.

48. Wong, *supra* note 42, at 5–6.

49. John C. Coffee, Jr., *The Lessons of DuPont: Corporate Governance for Dummies,* CLS BLUE SKY BLOG (June 1, 2015), http://clsbluesky.law.columbia.edu/2015/06/01/the-lessons-of-dupont-corporate-governance-for-dummies/.

50. Wong, *supra* note 42, at 5, 30.

In order for activist investors to benefit from joining wolf packs, they must be careful to buy in to the targeted company while remaining in compliance with the applicable securities laws. Under the Securities Exchange Act of 1934, if the group's collective holdings exceed five percent of the company's outstanding common stock, then, regardless of how small individual holdings are, each member of the group will be subject to enhanced disclosure requirements under Securities Exchange Act Section 13(d).[51] The Williams Act refers to the 1968 amendments to the Securities Exchange Act of 1934, including Schedule 13D.[52] Congress created this Act to protect companies against corporate raiders' takeover attempts, by filling then-existing gaps in federal and state corporate law.[53]

While five percent is the first threshold that triggers requirements under the Securities Exchange Act, wolf packs' obligations increase if the group's collective holdings exceed ten percent of the company's outstanding stock.[54] When this threshold is met, all members of the group are not only required to comply with reporting obligations but also with profit restrictions under Section 16(b) of the Securities Exchange Act.[55] For example, Section 16(b) prohibits profits on purchases and sales of the company's shares within any six-month period.[56] The rule states:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reasons of his relationship to the issuer, any profit realized by him from any purchase and sale. . . of any equity security. . . within any period of less than six months, shall inure to and be recoverable by the issuer.[57]

In other words, this provision was intended to prevent owners of more than ten percent of a corporation from using inside information to make a profit on short-swing security transactions.[58]

This leaves us with two questions: (1) Do these rules contain a loophole that wolf packs are exploiting, or (2) are wolf packs merely succeeding in spite of the law because they are disobeying it? In other words, are wolf packs succeeding while complying with the law by acquiring less than five percent of shares, an amount that is sufficient to create a control block? Or, are they succeeding because of their ability to circumvent the law based on a technicality about the definition of a "group"?

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51. Flaming, *supra* note 38.

52. *See* Smilan et al., *Preventing 'Wolf Pack' Attacks: Williams Act May Help Companies Fend off Activist Hedge Funds*, NAT'L L.J. (Nov. 20, 2006), https://www.lw.com/upload/pubContent/_pdf/pub1710_1.pdf.

53. Nagel et al., *supra* note 15.

54. Securities Exchange Act, 15 U.S.C. § 78p(b) (West 2011).

55. Flaming, *supra* note 38.

56. *Id.*

57. 15 U.S.C. § 78p(b).

58. Securities Exchange Act, § 16(b), 15 U.S.C. § 78p(b); *see also* Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232 (1976).

There two ways that wolf packs might successfully accumulate a control block of shares without being detected. The first is that wolf packs may accumulate a block of slightly less than five percent of shares; as such, the block remains undetected by the SEC because it falls below the statutory threshold. If despite falling below five percent this ownership percentage is still effectively a control block, most other shareholders in the company would nonetheless be minority shareholders. In this manner, even though five percent seems like a relatively small holding, it would be enough to garner significant control in the entity. There is some support for this theory: a block-holder is defined as a shareholder who holds at least five percent of a company's shares.[59] This means that once wolf packs are officially deemed to be block-holders, they are required to register as a group under Schedule 13D—*if* they have "an agreement to act in concert."[60]

It is the latter requirement of "an agreement to act in concert" which raises the second possibility: wolf packs are not complying with the disclosure requirements even *after* they collectively acquire more than five percent, because they fall outside the statutory definition of a "group." There is strong evidence for this theory. For example, "through stock watch services, companies may discover that they have many more activists in their stock than Schedule 13D filings and publicly available information reveal."[61] Although shareholders act in concert, they are not affiliated with each other and do not form a "group" under SEC rules.[62] In this manner, wolf packs deliberately avoid the group characterization to circumvent disclosure rules under the securities laws.[63] Investors can collectively accumulate big stakes and act together without actually coordinating, "much as schools of fish or flocks of birds manage to move in unison without members talking to each other."[64] This phenomenon may be possible due to the lack of a public agreement acknowledging the formation of a wolf pack.[65] As such, having an undocumented mutual understanding may virtually guarantee that these shareholder groups cannot be punished for failing to comply with the disclosure requirements on "groups." In order to establish liability, moreover, the SEC must show that a tippee (receiver of

59. Alex Edmans, *Blockholders and Corporate Governance* 2 (Ann. Rev. of Fin. Econ., Working Paper, 2014), https://ssrn.com/abstract=2285781.

60. Leonard Chazen & Jack Bodner, *Conscious Parallelism May Justify a Wolf Pack Pill*, LAW360 (May 27, 2014), https://www.cov.com/~/media/files/corporate/publications/2014/05/conscious_parallelism_may_justify_a_wolf_pack_pill.pdf.

61. Flaming, *supra* note 38.

62. *Id.*

63. Anand & Mihalik, *supra* note 25.

64. Gregory Millman, *The Morning Risk Report: How Activist Wolf Packs Work,* WALL ST. J.: RISK & COMPLIANCE J. (Feb. 19, 2015), https://blogs.wsj.com/riskandcompliance/2015/02/19/the-morning-risk-report-how-activist-wolf-packs-work/.

65. Chazen & Bodner, *supra* note 60.

information about wolf pack activity) paid or promised a personal benefit to the tipper of information. This is a significant burden.[66]

A desire to avoid triggering these rules provides strong incentives to ensure that there is no public agreement among the wolf pack members.[67] Therefore, wolf packs actively appear to be uncoordinated, and the process by which they form appears to be subtle.[68] Indeed, wolf pack activity is often undetectable by the public.[69] If it is possible that activist investors often follow each other without discussing it, which appears to be the case,[70] then the disclosure rules currently do not serve their purpose of protecting against *all* effective control groups; uncoordinated wolf packs do not meet the definition of those control groups who are required comply with the rules. For example, changing the rules to require disclosure after the group's collective holdings reach three percent would have little effect, because regardless of what the disclosure requirement is, wolf packs would effectively be able to ignore it. In this way, the statutory requirement could demand disclosure after a group's collective holdings exceed a value as low as two percent or as high as eighty percent, and these requirements still would not trigger the disclosure obligations set forth in the rules because wolf packs would still not meet the definition of "group" in the statute due to their lack of active coordination.

While activists have traditionally focused on small and significantly underperforming companies,[71] there are growing concerns that even large, well-known public companies (which are not necessarily poor performers) may be vulnerable to attacks by wolf packs.[72] This worry exists partially because the current statutory arrangement allows activist investors to circumvent securities regulations and takeover defenses triggered by holding thresholds.[73] According to John Coffee, the main advantage of joining a wolf pack is that it offers "near riskless profit."[74] First, riskless profits are obtainable because when the hedge fund leading the pack informs other activists of its intent to organize a wolf pack, it does not breach any fiduciary duty to the target's shareholders.[75] This means that the lead activist may inform other potential wolf pack members of its investment in the target company before its public disclosure of the investment because "sharing this information with other activists does not cost the lead activist

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66. Coffee, *supra* note 8.

67. *See* Flaming, *supra* note 38.

68. *See* Brav, Dasgupta, & Matthews, *supra* note 37.

69. Flaming, *supra* note 38.

70. Wong, *supra* note 42.

71. Mary Jo White, Chair, SEC, A Few Observations on Shareholders in 2015, (March 19, 2015), https://www.sec.gov/news/speech/observations-on-shareholders-2015.html#_ftn8.

72. Smilan et al., *supra* note 52.

73. Wong, *supra* note 42.

74. Coffee, *supra* note 49.

75. *Id.*

so long as it has finished accumulating its initial position."[76] Secondly, this kind of exploitation of material, non-public information is legal.[77] Additionally, "an abnormal trading gain of 7–8% is a statistical near-certainty on the day of the Schedule 13D filing," so others will join in to get in on the profit.[78] Since a short-term profit is virtually riskless, it is not difficult for an activist hedge fund to assemble a wolf pack that holds twenty to thirty percent of shares or more of the target without triggering disclosure.[79]

In terms of understanding how wolf packs work, it is important to note that there is not always a designated leader of the pack.[80] One hypothesis is that wolf packs sometimes arise spontaneously because investors monitor and target the same firms around the same time.[81]

Whether there is a designated leader or not, by forming wolf packs, activists' risk is very low because they can cumulatively gain significant power with relatively little investment. For example, activists largely increase their chances of winning proxy contests and can accumulate an undetected control block of shares with relatively small holdings.[82] By getting the support of other shareholders via a proxy contest and by accumulating control, activists can elect their choice of directors and oust the current board.[83]

According to Charles Nathan, former Co-Chair of Latham & Watkin's Corporate Governance Task Force, "the market's knowledge of the formation of a wolf pack (either through word of mouth or public announcement of a destabilization campaign by the lead wolf pack member) often leads to additional activist funds entering the fray against the target corporation, resulting in a rapid (and often outcome determinative) change in composition of the target's shareholder base seemingly overnight."[84]

Either way, given the strong incentives to maximize profits in conjunction with low risks for wolf packs to form, it is not surprising that wolf packs are attempting to gain control of corporations. When high incentives are present with low risks, a framework is established for wolf packs to alter the corporate environment.

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76. Flaming, *supra* note 38.

77. Coffee & Palia, *supra* note 1, at 7 n. 14 (quoting Alon Brav, Wei Jiang, Frank Partnoy, and Randall S. Thomas, *Hedge Fund Activism, Corporate Governance and Firm Performance*, 63 J. FIN. 1729 (2008)).

78. *Id.*

79. *Id.*

80. *See* Wong, *supra* note 42, at 11–12.

81. *Id.* at 12.

82. *See* Flaming, *supra* note 38.

83. *See* Lu, *supra note* 4, at 774.

84. Charles M. Nathan, *Recent Poison Pill Developments and Trends*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (May 12, 2019), https://corpgov.law.harvard.edu/2009/05/12/recent-poison-pill-developments-and-trends/; *see also* Brav, Dasgupta, & Matthews, *supra* note 37.

III. Maximizing Shareholder Value: Theories on the Long Term Impact of Wolf Packs

It is highly controversial whether wolf packs can be advantageous to companies. Some view them as short-term predators who merely attempt to boost the stock price of their target company for short-term gain, while exiting before the long-term costs are felt.[85] Others view them as the "natural champions of dispersed and diversified shareholders."[86]

When considering whether wolf packs are more likely to help or hurt companies, it seems that part of the divergence in opinion comes from different ideas of what it means to maximize shareholder value. It is indisputable that "increasing shareholder value is of prime importance for the management of a company," and all else being equal, "the higher the shareholder value, the better it is for the company and management."[87]

Controversy arises from different beliefs about what shareholder value is, how to maximize it, and how the power dynamics of corporations should be altered in order to do so. Those who are most concerned about the motives of directors may point out that faulty decisions by management can damage shareholder value; as such, decision-making power should shift to shareholders.[88] When shareholders have more power through tactics such as wolf pack activism, however, this shift may *also* damage shareholder value.

The definition of shareholder value is also in dispute. Some argue "the premise of shareholder value, properly understood, is that if a company builds value, the stock price will eventually follow."[89] Others believe that the definition of shareholder value is simply a general "desire to maximize profits."[90] While this latter understanding of shareholder value sounds like it may apply to both short-term and long-term profits, it often focuses on the benefits of maximizing only the *short-term* stock price of a company

A. *"Stock First" Theorists*

Those who believe that maximizing shareholder value is all about maximizing the short term stock price are also more likely to believe that wolf packs are beneficial to corporate governance. The basis for this view is a belief that when a company's stock price increases, the value of the company follows.[91] Under this view, an initial boost in a stock's price can

85. Coffee & Palia, *supra* note 1.

86. *Id*.

87. *Definition of 'Shareholder Value*, Economic Times, http://economictimes.indiatimes.com/definition/shareholder-value.

88. *Id.*

89. Michael J. Mauboussin, *What Shareholder Value is Really About,* Harv. Bus. Rev. (Oct. 3, 2011), https://hbr.org/2011/10/ceos-must-understand-what-crea.

90. Myles Udland, *GMO's Capital's James Montier Destroys The Idea That Maximizing Shareholder Value Is Good,* Bus. Insider (Dec. 2, 2014), http://www.businessinsider.com/gmos-montier-maximizing-shareholder-value-is-the-worlds-worst-idea-2014-12.

91. Mauboussin, *supra* note 89.

create long-term wealth sustainability in a company. Herein, I refer to subscribers to this belief as "stock first" theorists.

Congress seems to subscribe to the "stock first" interpretation of shareholder value, as it has recognized that takeovers of underperforming companies can benefit shareholders and the economy as a whole.[92] The idea is that activist shareholders (investors) can create value not only for themselves but also for passive shareholders by assuming the liabilities necessary to bring about a market-driven corporate change.[93] Often, activist shareholders will purchase a large stake in a public company and then lobby the company's management to implement changes that the investors believe would increase shareholder value.[94] More specifically, activists may influence the "governance, capital structure decisions, and operating performance of target firms."[95]

In addition to Congress, the SEC also seems to hold the view that the involvement of activists is not a trend which it should guard against.[96] Mary Jo White, former Chair of the SEC, commented in 2015 on the state of shareholder activism, stating "activism seeks to bring about important changes at companies that can increase shareholder value."[97] She seems to have endorsed wolf pack activism specifically when she added, "an activist may also begin a campaign behind the scenes, but go public if it believes it is not being heard or making enough progress. . . [which] can be compatible with the kind of engagement that I hope companies and shareholders can foster."[98]

To connect this idea with the big picture and the players described in Section I, it would appear that hedge funds are more likely to subscribe to the "stock first" theory than the "value first" theory, at least for the purposes of persuading the SEC not to change its rules. Value first theorists believe that if a company builds value, the stock price will eventually reflect that value. This theory focuses on the long-term value of the company and considers a multitude of factors when making that determination, rather than viewing a short jump in stock as the main indicator. The current market does not necessarily reflect the long-term value of a company. For example, according to a value theorist, a dip in stock price does not necessarily mean the value of the company has lowered. If the primary belief in corporate governance is that wolf packs are actually helpful to public companies regardless of their personal motives, the laws are likely to reflect that societal belief and remain beneficial to hedge funds seeking short-term "riskless profits".

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92. *See* Nagel et al., *supra* note 15.

93. *See id.* at 20; *see also* Alon Brav, Wei Jiang, & Hyunseob Kim, *Hedge Fund Activism: A Review,* 4 FOUND. & TRENDS IN FIN. 185 (2009).

94. Lu, *supra* note 4.

95. Brav, Jiang, & Kim, *supra* note 93, at 51.

96. Lipton, *supra* note 9.

97. White, *supra* note 71.

98. *Id.*

An argument reflecting the "stock first" theory may go as follows: even if investors' motives are for their own short-term benefit, long-term costs are not necessarily a result. The stock market is long-term oriented and reflects cash flows many years into the future, regardless of whether the focus of a particular investor is short-term or long-term.[99] Additionally, research shows that the market reflects long-term value.[100] For example, "if the synergies of combining businesses exceed the premium the acquirer pays"—which would reflect a long-term benefit and short-term cost—"the stock of the acquiring company goes up irrespective of the immediate earnings impact."[101]

While much regulatory debate in corporate governance focuses on the effect of legal rules, "commercial norms and practices may be equally, or more, important."[102] Promoting the "stock first" theory may positively skew cultural views about wolf packs, and affect the laws that govern them, as lawmakers are influenced by general public norms. Therefore, it is in a hedge fund's best interest to subscribe to the "stock first" theory.

As a point of comparison, some developments in Australia show that "[C]ommercial practices may in some instances effectively subvert legal rules and generate their own convergence pressures."[103] These developments are evidence supporting the instinct that the societal views surrounding corporate theories can shape law, or at least impact what is culturally acceptable under existing laws.

At least in terms of narrow self-interest, however, it does not matter whether activist hedge funds and other members of wolf packs secretly subscribe to the "value first" theory and believe that they are hurting the long-term growth of companies. This is because they generally will sell their stake in the company before they would feel this impact.[104]

B. *"Value first" Theorists*

A different line of thought about maximizing shareholder value is that the value of the company must first increase, which will in turn drive up the stock price. In other words, if a company builds value, the stock price will eventually reflect that value.[105] In this Note, I will refer to those who hold this belief as "value first" theorists. This Note hypothesizes that "value first" theorists are more likely to interpret the increase of wolf pack activism as a threat to the well-being of targeted companies.

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99. Mauboussin, *supra* note 89.

100. *Id.*

101. *Id.*

102. Hill, *supra* note 11, at 3.

103. *Id.*

104. *See generally* Brav, Jiang, & Kim, *supra* note 93 (showing that activists exit on average within 266 days after initial filing).

105. *Id.*

This hypothesis intuitively makes sense, because if the positive stock return is merely caused by the public announcement of the activists' campaign,[106] (rather than the natural success of the company) wolf pack activity increases the stock price before that price truly reflects the value of the company. In other words, the stock price only rises due to an announcement, which is something artificial and in a sense completely unrelated to the company's actual success. Therefore, this artificial inflation of stock price creates a disparity between the true value of the company and the price of its stock. Since the stock market over time will reflect the true value of the company, the stock price will dip back down in the future because no new value has been created.

By contrast, a "stock first" theorist would believe that this jump in stock price truly does reflect the current and long-term value of the company, despite the fact that it was merely caused by an announcement by activists. They would want to maximize profits at any given moment by driving the current stock price up at all costs, while "value first" theorists would consider it harmful for this belief to drive company decisions because prioritizing short-term increases in stock price could come at the cost of the long-term value of the company. "Value first" theorists believe that this price inflation is merely a bubble that will eventually pop, causing long-term harm.

It follows that if "value first" theorists believe that the value of the company must increase before the stock price to achieve long-term sustainable growth, and that a public announcement of an activist's campaign does not increase the actual value of the company when it causes the stock to go up, then they would view wolf packs to be harmful in reaching the goal of long-term shareholder value maximization.

IV. Analysis of Theories

These contradictory theories produce a number of questions: Is it a good thing that power has been shifted from corporate boards to activist shareholders through wolf pack activism? Or, are activists' short-term motives hurting companies in the long run? Whose motives are least worrisome—the board's or activist shareholders'? Ultimately, which theory is correct? It is intuitive that if the value of a company increases, the stock price will follow. But is it necessary for sustainable long-term growth that it happens in that order?

This section will explore the accuracy of the "stock first" theory. It will consider whether it is really true that wolf packs and other activist shareholders can create value not only for themselves but also for passive shareholders and whether it is true that the market always reflects long-term value.[107]

106. *See* Wong, *supra* note 42.

107. *See* Nagel et al., *supra* note 15; *see also* Brav, Jiang, & Kim, *supra* note 93.

A. *Into the Minds of Hedge Funds: Reasons for Quickly Exiting Companies*

Critics of wolf packs argue that hedge funds "purport to be good at building long-term engines of economic growth, but are public-spirited enough to leave the resulting growth powerhouses after a few years, even though their influence on the corporation will last far beyond that."[108] There is a lot at stake:

> [T]he pressure to respond to the short-term demands of Wall Street has paved the way for an economy in which companies are increasingly disconnected from the state of the nation, laying off workers in huge waves, keeping average wages low and threatening to move operations abroad in the face of regulations and taxes.[109]

The pursuit of shareholder value has long been associated with failures to invest in long-term growth.[110] Accordingly, the label of wolf packs as short-term predators is not meritless. One study showed that activists exit on average within 266 days after the filing of the initial Schedule 13D.[111] Additionally, *most* members of a wolf pack exit the target company within a year.[112]

One critical question is: if the stock market is truly long-term oriented and reflects cash flows many years into the future, regardless of whether the focus of investors is short-term or long-term,[113] then why do activist hedge funds choose to leave their target companies within a year? In other words, after they have recruited a group of activist investors and spent time changing company policies, activists are in the best position to know if they are implementing long-term positive changes to the company, and nonetheless, *most* members of a wolf pack exit the target company within a year.[114] Why are the groups in the best position to know whether they have created long-term benefits for a company so eager to leave it?

There are several possibilities. An optimistic view highlights that wolf packs are truly "stock first" theorists, meaning they *do* believe they are creating long-term wealth sustainability for the target companies that they are taking control of, but they still exit within a year because they believe that those long-term benefits are outweighed by greater short-term financial benefits they can find elsewhere. As hedge funds and other activist investors, by definition, actively spend more time promoting their values

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108. Strine, *supra* note 12, at 1873.

109. Jia Lynn Yang, *Maximizing Shareholder Value: The Goal That Changed Corporate America*, THE WASHINGTON POST (Aug. 26, 2013), https://www.washingtonpost.com/business/economy/maximizing-shareholder-value-the-goal-that-changed-corporate-america/2013/08/26/26e9ca8e-ed74-11e2-9008-61e94a7ea20d_story.html?utm_term=.Dcb77180d66a.

110. Alfred Rappaport, *Ten Ways to Create Shareholder Value*, HARV. BUS. REV. (Sept. 2006), https://hbr.org/2006/09/ten-ways-to-create-shareholder-value.

111. Brav, Jiang, & Kim, *supra* note 93, at 203.

112. Lu, *supra* note 4.

113. Mauboussin, *supra* note 89.

114. Lu, *supra* note 4.

in companies than passive investors, it makes sense that they would want to receive more money than a passive investor. All else being equal, someone who puts more time into something expects to get more out of it. It makes sense that wolf pack activists *should* receive more than a passive investor in this circumstance to make up for the greater cost of time and energy. Otherwise, they'd have no economic incentive to spend the time and money required above that of a passive shareholder. That the nature of the hedge fund industry is fast paced, with members accumulating short-term gains, does not necessarily reflect the proposition that they are not also creating long-term value for the companies that they quickly exit.

A more skeptical possibility is that members of wolf packs are actually "value before stock" theorists. As those who most understand the changes they have implemented in the target company, they are exiting because they believe they have created only short-term value (and possibly even long-term harm). They want to leave before the stock bubble bursts.

As hedge funds are in the best position to understand the impact they are having on companies, this focus on activist shareholders' true beliefs is one avenue that may help determine which theory best reflects market realities. A major challenge with figuring out which theory best represents the condition of the market is that activists' actions look the same regardless of which theory is correct: they exit the company. Additionally, activists have an incentive to promote the theory which makes their impact on corporate governance look best.

B. *Long Term Effects of Wolf Packs*

Mary Jo White, the former chair of the SEC, has acknowledged that the growing presence of hedge funds has "undeniably changed the corporate landscape."[115] While the ultimate question for whether the laws surrounding wolf pack activism need reform is determining whether hedge funds and other activist shareholders have improved the corporate landscape, one key part of this analysis is determining which of the competing theories of shareholder value is most accurate. Aside from exploring the intentions of hedge funds, another avenue that may guide this investigation involves examining of the long-term effects that wolf packs create for their target companies. It is important to compare these effects with any potential alternative effects resulting from different power dynamics. In other words, analyzing in the abstract whether wolf packs are creating long-term benefits or harm for their target companies may be the wrong way to frame the inquiry, at least in terms evaluating possible reforms. This is because it is entirely possible that both activist hedge funds and corporate boards have incentives that may hurt companies, and it is not clear which group has a more impactful effect. On the other hand, shifting power away from one group necessarily implies shifting it to the other. A better way to frame the question, therefore, is whether wolf packs are

115. White, *supra* note 71.

harming target companies, and if so, what would be the result if more power were to be shifted to the board?

One criticism of institutional investors is that they promote short-term thinking over long-term sustainability by creating compensation structures that prioritize short-term price increases over long-term wealth creation.[116] Additionally, those who "buy and sell stock rapidly" and "do not intend to be around when the consequences of corporate policies proposed by activist hedge funds come to fruition – will give great weight to the short-term effect of policies, without adequately considering whether those policies create too little long-term investment or too much leverage and externality risk."[117] This problem is seen as a defining element of corporate scandals, including Enron.[118] However, it is not clear whether shifting power from these institutional investors to the board would improve incentives for long-term wealth creation. Directors have incentives to keep stock prices inflated so that they can avoid takeover bids and maintain their position within the company.[119] Directors may also be motivated to inflate short-term stock prices at the expense of shareholder interests if they want to take the best advantage of their stock options.[120] Directors may also be generally ineffective, and if they are secure in collecting an annual salary without fear of getting fired by unhappy shareholders, then they may lack the motivation to improve performance. In other words, corporate managers who are more vulnerable to getting fired deliver better returns.[121] If power shifted too much towards corporate managers and away from shareholders, there may still be negative impacts on corporate growth.

Keeping in mind that alternative situations to hedge fund activism also have flaws,[122] one study by Professor Lucian Bebchuk suggests that wolf pack activity has harmful long-term effects.[123] Professor Bebchuk's study is particularly useful because it looks specifically at the effects of activist hedge funds on companies with control groups. These control groups are the result of shifting more power to directors. This creates a useful comparison for determining which alternative is preferable for the long-term financial health of companies. This study found that "in the years following the intervention of activist hedge funds, the firm value of hedge fund

116. Hill, *supra* note 11.

117. Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 458–459 (2014).

118. Hill, *supra* note 11.

119. Katharine Jackson, *Towards a Stakeholder-Shareholder Theory of Corporate Governance: A Comparative Analysis*, 7 HASTINGS BUS. L. J. 309, 310 (2011).

120. *Id.*

121. Strine, *supra* note 117.

122. *See* Jackson, *supra* note 119, at 323.

123. *See* Coffee, s*upra* note 8, at 2.

targets deteriorates (sizably) compared to control firms.[124] There is also a "growing recognition of the adverse effects of these attacks on shareholders, employees, communities, and the economy."[125]

Additionally, when the focus has been on increasing the short-term stock prices of companies, which is the motivation of wolf packs, various companies have experienced increases in stock price even while the company suffers.[126] For example, changes in IBM saw the company's stock price rise during the 1990's at the same time that it undertook massive layoffs.[127] While the interests of corporations and communities may have at one time been closely aligned, this is no longer the case.[128] In modern times, "across the United States, as companies continue posting record profits, workers face high unemployment and stagnant wages."[129]

These worrisome facts suggest that the "value first" theory is the best of the above theories. These facts support the view that short-term stock increases do not correlate with long-term increases in company value. Even worse, short-term stock increases can occur at the same time that companies are shrinking, and their long-term value is decreasing.

V. Reform

After examining the impact of wolf packs on the corporate environment and the broader economy, the next issue is whether the law should be reformed to protect companies from the threat of wolf packs.

It seems clear from the analysis of the "stock first" theory of shareholder maximization that it is not the short-term boost in stock price caused by a wolf pack that leads to a company's increased value. However, that does not mean that wolf packs are useless or incapable of contributing to long-term growth. Wolf packs are not entirely harmful, as they can have a powerful effect on unsuccessful companies by removing ineffective boards. The biggest problem seems to be that activist shareholders in wolf packs are motivated by short-term incentives, which can sometimes have a harmful long-term impact on companies. Since wolf packs can be helpful in motivating positive change but can also be harmful in effecting change that is detrimental to the company in the long run, it is important to consider how to best align the interests of activist shareholders with the interests of passive shareholders and with the long term sustainability of their target companies.[130] In doing so, it is also important to

124. *Id.*

125. Martin Lipton, *The Threat to Shareholders and the Economy from Activist Hedge Funds*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Jan. 14, 2015), https://corpgov.law.harvard.edu/2015/01/14/the-threat-to-shareholders-and-the-economy-from-activist-hedge-funds/.

126. *Cf.* Udland, *supra* note 90.

127. *See id.*

128. *See* Yang, *supra* note 109.

129. *Id.*

130. Strine, *supra* note 117.

consider how to strike the right power balance between boards and activist shareholders. The goal should be to reach a corporate governance structure in which directors have incentives to perform well and are kept in check by the fear of a wolf pack takeover, while wolf pack activism is also kept in check by restraints that encourage activism to better align with the long-term best interests of the target companies.

A. *Increase Accountability*

Wolf packs are more likely to effectuate positive long-term corporate change when their self-interest is aligned with long-term goals. To align wolf pack activist interests with long-term goals, there should be a process of accountability where wolf packs and other activist investors are responsible for the interests of investors who have "entrusted their capital to the market for the long-term."[131] Some commentators have proposed the following method to increase accountability of activist investors: fiduciary duties for activist shareholders akin to those of directors to protect the best interests of the corporation.[132] This change would require that those who "wield direct voting power over productive corporations do so in a manner faithful to the best interests of those whose money they control," including shareholders who are investing in the company's long-term growth.[133] If this duty existed, wolf packs would still be incentivized to reap profits and to takeover companies that are inefficient, but they would also be encouraged to channel their efforts towards inefficient companies and to create policies that would consider the company's long-term growth.

While in theory this may sound like an ideal solution to better align the interests of short-term activist investors with long-term shareholders, there would be many difficulties with this approach that would most likely outweigh the benefits. First of all, there would be ambiguity about when the fiduciary duty triggers for a shareholder, especially with wolf pack activism where it is often unclear at what moment shareholders are acting in concert before they are officially deemed to be a group. Other relationships that impose fiduciary duties are much clearer. For example, a fiduciary duty between a husband and wife is clearly imposed at the moment of marriage.[134] In the case of shareholders, it would not be fair to impose a fiduciary duty because they may have exposure without knowing when they were bound and when they could act solely in their own self-interest. Furthermore, it would be dangerous to discourage shareholders from acting in their own self-interest because the right to do so fuels investment and supports the economy. The chilling effects of imposing duties on insti-

131. *Id.* at 474.

132. *Id.*

133. *Id.* at 476.

134. *See* Ken LaMance, *Fiduciary Duty of Husband and Wife Lawyers*, LEGAL MATCH (June 11, 2014), http://www.legalmatch.com/law-library/article/fiduciary-duty-of-husband-and-wife.html.

tutional investors may discourage takeovers of inefficient companies, which could harm the economy by reducing the incentives for investment.

There may be better ways to increase accountability of activist investors and thereby incentivize them to have an eye towards the long-term growth of companies. For example, if when voting for policies, activist investors were required to explain their motives, they may be more likely to support policies aimed at long-term growth.[135] Activist investors would be required to disclose the reasoning behind their proposals and that process would create pressure to explain the long-term benefit of their proposals. Ideally, this added pressure to disclose reasoning, couched in terms of long-term sustainable growth, would incentivize wolf packs to narrow the scope of companies they target to weaker companies that are in need of takeover. It would be significantly easier for them to explain how their proposals would benefit the long-term growth of target companies if those companies were actually in need of help, rather than large, successful companies that may actually be harmed by intervention in the long-run. Activist shareholders could sidestep this solution by refusing to be transparent about their motives, but it would nonetheless require disclosure with which other shareholders, and indeed the broader public, could agree or disagree.

Although requiring activists to explain their motives regarding various proposals is an imperfect solution, there may not be a perfect solution. Depending on the situation, wolf packs can be beneficial in quickly and effectively turning around an ineffective company, or they can be harmful in unnecessarily interfering with relatively strong companies for short-term gain. Regulating wolf packs risks undercutting the benefits they sometimes provide in corporate governance. Indeed, any solution which shifts too much power away from activist investors risks causing other problems, such as entrenching leadership of inefficient companies.

B. *Narrow the Disclosure Gap*

Another method aligning the interests of wolf packs more closely with those of long-term shareholders is to increase the SEC's disclosure requirements regarding ownership of shares. If long-term investors can become aware of the presence of a wolf pack at an earlier stage, their understanding that a corporate change is taking place may incentivize them to vote on policies and keep wolf packs in check. This method also would give less time for the snowball effect to take place in which activists tip each other off before any disclosure requirements are triggered. In this way, increasing the disclosure requirements would be likely to help in counteracting the negative impacts of wolf packs and other activist shareholders who are only motivated by short-term financial gains.

Existing securities laws give activists a long, ten-day period before they are required to report a cross in the ownership threshold they hold in pub-

135. Strine, *supra* note 117.

licly traded companies.[136] This delay gives activist hedge funds plenty of time to privately spread the word about their plans and to reap the benefits of wolf pack attacks, without disclosing their ownership to the target company or other investors.[137] During this ten-day period, activists can pool their financial and informational resources, which reduces the cost of seizing corporate control.[138] "Empirical evidence is that an extraordinary level of trading occurs during the ten day window period before the Schedule 13D is filed."[139]

The proposal to limit the large, short-term gain that wolf packs are able to benefit from would be to narrow this ten-day period from the time of reaching the five-percent ownership threshold to the time that disclosure is required. In this way, other shareholders who care deeply about the long-term growth of their company would not be left in the dark. This change may be possible, since it has been accomplished in other countries: "Both the U.K. and Australia have much shorter window periods, and the 'wolf pack' is not readily observed in these jurisdictions."[140]

The problem is that this proposal may be unrealistic in the United States because of various differences in our corporate governance scheme. Shortening this period may not be practical, for example, because disclosures are usually filed by attorneys who need time to communicate with each other and with their clients. It would likely be too much of a burden to shorten the disclosure period below ten days. Another problem is that "scarce resources limit the ability of the U.S. Securities and Exchange Commission (SEC) to police the formation of undisclosed hedge fund groups, and the private remedies available to protect public companies from control bids by such groups are of limited effectiveness."[141]

C. *Conclusion*

In conclusion, since wolf packs can be beneficial in some circumstances and harmful in others, any reforms to the status quo must be carefully crafted so as not to shift the balance of power between shareholders and directors in a way that will ultimately cause harm to the economy. In other words, any approach that would completely eliminate wolf packs would be dangerous as it would also destroy the benefits they provide through takeovers of poorly-managed companies. It is important to look more closely at the facts and circumstances surrounding situations in which wolf packs benefit or harm companies and tailor reforms to those situations. Rather than try to uniformly decrease the power of wolf packs (therefore decreasing not only the harm but also the benefits they pro-

136. Mirvis, *supra* note 30.

137. *Id.*

138. *Cf.* Lu, *supra* note 4.

139. Coffee, *supra* note 8, at 4.

140. *Id.*

141. Smilan et al., *supra* note 52.

vide), reforms should be aimed at altering the short-term incentives of activists so that they more closely align with the long-term growth of their target companies. One method is to require disclosure of activists' long-term incentives when they make proxy proposals to effectuate change in a company, but this is just a starting point. Scholars, practitioners, Congress, and the SEC should collaborate to propose other potential methods of using this framework to align the interests of all stakeholders in companies targeted by wolf packs.