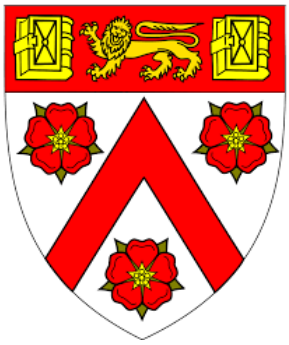
The Evolution of Hedge Fund Activism:

From Corporate Raiders to Sustainability Crusaders?



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Declaration

This thesis is the result of my own work and includes nothing which is the outcome of work done in collaboration except as declared in the Preface and specified in the text.

I further state that no substantial part of my thesis has already been submitted, or is being concurrently submitted, for any such degree, diploma or other qualification at the University of Cambridge or any other University or similar institution except as declared in the Preface and specified in the text.

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The Evolution of Hedge Fund Activism:
From Corporate Raiders to Sustainability Crusaders?

Anna Louise Christie

Abstract

The prevailing rhetoric associated with hedge fund activism is almost universally negative. This thesis provides new evidence of activist hedge fund behavior that contradicts this dominant narrative. The principal idea underpinning the thesis is that the conventional picture of hedge fund activism requires updating to account for two key recent phenomena: activist board representation and environmental, social, and governance ("ESG") activism.

The thesis makes at least four important contributions to academic and policy debates on hedge fund activism. First, through analyzing original hand-collected data on activist hedge fund campaigns, it demonstrates that a relatively new form of activism – activist board representation – tends to involve a longer-term approach to value creation through strategic and operational changes, rather than the short-term financial engineering that activist hedge funds are commonly criticized for engaging in. Second, it builds upon the study of activist board representation campaigns to argue that activist hedge funds may be well positioned to play a unique role in ESG activism by nominating specialist climate directors to corporate boards. Third, it outlines how the phenomenon of activist board representation exposes the deficiencies of the independent monitoring board and provides suggestions for potential corporate governance improvements. Finally, it theorizes the incentives behind ESG hedge fund activism, thus providing early insights into this rapidly evolving practice.

The thesis is structured as follows: Part I (Chapters 1 and 2) situates hedge fund activism and the role of the board in traditional and contemporary corporate governance debates. Chapter 1 examines the intellectual foundations underpinning the monitoring board as a response to the shareholder-manager agency problem and challenges its continued dominance in light of pressing societal challenges facing corporations. Chapter 2 critiques

the narrative of short-termism that is prevalent in politics, the media, and corporate practice, which can obscure learning from the campaigns of activist hedge funds. Part II (Chapters 3 and 4) examines activist hedge fund board representation campaigns. Chapter 3 introduces this new form of hedge fund activism and presents a theory and hypotheses on the potential value associated with this type of activism. Chapter 4 tests the hypotheses presented in the preceding chapter through an empirical study analyzing activist board representation campaigns at S&P 500 companies since 2010. Part III (Chapters 5 to 7) explores ESG activism. Chapter 5 develops a new account of sustainable capitalism using the building blocks of agency theory. It highlights the major shift to passive index investing and ESG investing and analyzes the monitoring shortfall on the part of global asset managers. Chapter 6 discusses ESG hedge fund activism and – building on the theory and the empirical study presented in Part II – proposes that activist hedge funds can play a unique role in a sustainable capitalism framework by nominating specialist directors with climate or energy transition expertise to corporate boards. Chapter 7 considers socially responsible activism and presents a theoretical framework of ESG hedge fund activism.

This thesis is dedicated to my mum, Shona Christie

I owe all my achievements to her infinite love and her support for my education

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Agnew for motivating and inspiring me, and for all the laughs we've shared. So many women at Newnham have taken the time to impart pearls of wisdom or provide words of support. I would like to thank Christina Angelopoulos, Barbara Blacklaws, Kate Fleet, Hilary Goy, Milena Ivanova, Sam Lucy, Jenny Mander, Emma Mawdsley, Róisín Owens, Alison Rose, Liba Taub, Sheila Watts, Tara Windsor and Lucy Zhao. Finally, I have had countless exquisite SCR dinners and lunches at Newnham, and I would like to extend my thanks to the fabulous catering team, especially Ash Catley and Monika Jankovics for their consistent good cheer. I will forever be grateful for being part of the incredible community at Newnham, it enriches my life in so many ways.

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In addition to presenting my work at Bocconi, Frankfurt, and Monash, I was privileged to have the opportunity to present my research for this thesis in a number of different conferences and workshops, including the Conference on Board-Shareholder Dialogue in Rome, the Enhancing Accountability in Corporate and Finance Governance conference in Prato, the ECGI Conference on Investor Sustainability Engagement in Amsterdam, the Shareholder Activism in Belgium conference in Brussels, the Queen Mary University Law School Sustainability Series, and the University of Oxford Business Law Discussion Group. I was also honoured to present my empirical study during a guest lecture for the Corporate Control Law and Finance course at the University of Oxford. I am grateful to all those who invited me to contribute to books and articles, and those who so generously gave me feedback on my work, including Paul Davies, Luca Enriques, Jill Fisch, Suren Gomtsyan, Dionysia Katelouzou, Martin Petrin, Vasile Rotaru, Giovanni Strampelli, Anna Tzanaki, Tom Vos and Thom Wetzer, among others. I also published some of the work of this thesis in the UC Davis Law Review, the Journal of Corporate Law Studies, the Revue Européenne du Droit, and in Cambridge University Press and Intersentia edited book collections. I appreciate the feedback from so many different reviewers.

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Introduction

"Who Bleeds When the Wolves Bite?" asked Leo Strine Jr., former Chief Justice of the Delaware Supreme Court, in his 2017 Yale Law Journal article critiquing the impact of activist hedge funds on human investors.[1] The prevailing rhetoric associated with activist hedge funds is almost universally negative. Vivid imagery of "Wall Street 'wolf packs' hunting down companies to close and jobs to eliminate"[2] depicts hedge fund activists as a destructive force in corporate governance. Activist hedge funds are accused of "attacking" companies, and their strategies are described as "edgy practices, accounting gimmickry, or never-ending cycles of spin-offs and mergers".[3] Overall, the picture presented is that activist hedge funds promote short-termism to the detriment of long-term sustainable value creation at the companies they target.

The motivation for the empirical study I conducted in this PhD project arose when I was studying cases of hedge fund activism that did not seem to fit this caricature. There appeared to be an abundance of recent examples of activist hedge funds presenting extremely detailed proposals to corporate management and other investors which articulated in impressive depth the perceived flaws in the strategy and operations of target companies. These campaign tactics looked a lot more substantive and potentially valuable compared to the financial engineering that activist hedge funds are commonly criticized for engaging in. As an example, one activist campaign that generated extensive media coverage was Starboard Value's proxy contest at Darden Restaurants in 2014. Here, Starboard presented a 294-page presentation explaining in intricate detail how the hedge fund planned to execute a turnaround of the company. This was focused largely on strategy and operations rather than resembling short-term financial wizardry. Similarly, an activist campaign by Trian Partners at Procter & Gamble in 2017 involved the hedge fund presenting a 93-page white paper detailing the shortcomings in P&G's corporate strategy. Uniquely, Martin Lipton, a vocal opponent of the campaign strategies of activist

[1] 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*, YALE L.J. 1870 (2017) [hereinafter *Who Bleeds*].
[2] MARK J. ROE, MISSING THE TARGET: WHY STOCK MARKET SHORT-TERMISM IS NOT THE PROBLEM 5 (2022).
[3] Strine, *Who Bleeds*, *supra* note 1, at 1874.

hedge funds, praised Trian's approach, noting that the Trian's campaign sought to "promote long-term investment and growth".[4]

What was different about these campaigns compared to the types of activities that activist hedge funds are most commonly criticized for engaging in? In the case of Darden, the strength of Starboard's proposal and the widespread dissatisfaction of other investors with the incumbent management led to a historic victory where the activist hedge fund succeeded in replacing the entire board of Darden with their own director nominees. At P&G, Trian's founder Nelson Peltz also joined the board, despite narrowly losing his proxy fight. These cases were outliers where activist campaigns had proceeded to full shareholder votes to determine whether the activist hedge fund nominee(s) should join the board. However, I found that there were many other cases at very large companies where activist hedge funds sought and secured representation on the target company board, either for one of their own managers or for carefully chosen non-affiliated independent directors. The campaigns seeking board representation seemed to involve the activist hedge funds putting forward detailed proposals on strategy and operations, rather than asking for dividends or share buybacks.

My key aim for the project then became to empirically test whether activist board representation might be associated with more beneficial forms of hedge fund activism rather than embodying the short-term financial engineering narrative that plagues activist hedge funds. Overarchingly, this thesis explores the general research question of whether the conventional portrayal of hedge fund activism requires updating to account for the phenomenon of activist board representation. Are activist hedge fund campaigns for board representation different from campaigns that do not seek board representation? Should this form of hedge fund activism be encouraged rather than discouraged?

While I conducted my empirical study on activist board representation campaigns at S&P 500 companies, a further important evolution of activist hedge fund strategies materialized. At this point, I had been exploring the potential benefits of activist board representation for some time. I was also thinking about the impact of hedge fund activism

[4] Martin Lipton, *The Trian/P&G Proxy Contest,* HARV. L. SCH. F. ON CORP. GOVERNANCE (Sept. 11, 2017) https://corpgov.law.harvard.edu/2017/09/11/the-trianpg-proxy-contest/.

on stakeholders and what role (if any) activist hedge funds might play in the environmental, social and governance ("ESG") movement. Then in 2021 a newly formed impact hedge fund, Engine No. 1, made history by successfully replacing a quarter of Exxon Mobil's board of directors. Crucially, this was the first ever campaign for activist board representation that focused on the issue of climate change. The narrative surrounding this particular activist campaign was very different to the normal short-termist narrative, with the hedge fund being applauded for its green activism, and the campaign being described as "the little hedge fund taking down Big Oil"[5]. This campaign motivated Part III of the thesis which explores the role of activist hedge funds – and especially activist board representation – in ESG issues. Thinking about the role of the board in sustainable value creation also inspired the focus in Part I which considers whether the board of directors needs to further evolve to meet the biggest challenges facing companies and society today.

In terms of jurisdictional scope, this thesis primarily focuses on the United States. There are various reasons for this. First, hedge fund activism and activist board representation originated in the United States. Therefore, there is a vast scholarship on hedge fund activism in the U.S., as well as a variety of prior empirical studies which I could use to inform the research questions and hypotheses for my own empirical study. Second, data on U.S. activist hedge fund campaigns tends to be much more accessible and comprehensive, compared with other jurisdictions. Third, U.S. companies have an outsized impact on the global economy. I did originally hope to include a comparative study with U.K. FTSE 350 companies. Unfortunately, there were so few activist board representation campaigns at such companies that it made the sample size in the dataset too small. In the thesis I do occasionally refer to campaigns or the laws of other jurisdictions to draw comparisons or to inform discussions on U.S. hedge fund activism. However, comparative studies are outside of the scope of this PhD thesis.

This thesis contributes to multiple central debates in corporate governance, including whether hedge fund activists are heroes or villains, the role of the board in corporate

[5] Jessica Camille Aguirre, *The Little Hedge Fund Taking Down Big Oil*, N.Y. TIMES MAG. (Oct. 13, 2021), https://www.nytimes.com/2021/06/23/magazine/exxon-mobil-engine-no-1-board.html.

governance, and the role of different types of investors in the ESG movement. It makes several important contributions to these academic and policy debates, as follows.

This thesis fills a gap in the literature by analyzing recent cases of hedge fund activism at S&P 500 companies. A study of activist campaigns at such large companies has not been seen in the literature before. I contribute a hand-collected dataset covering all activist hedge fund campaigns at S&P 500 companies from 2010 to 2019. Therefore, the data presents original, up-to-date, empirical evidence of activist campaigns at the most economically and socially significant companies in the United States. Hedge fund activism is a fast-moving phenomenon and even very recent academic scholarship on hedge fund activism has contained caveats due to reliance on empirical studies published in the late 2000s.[6] Some scholars have also downplayed the potential impact of activist hedge funds due to the perceived focus on their campaigns primarily targeting smaller companies.[7] My new data can help to avoid such caveats being necessary in future academic scholarship. Moreover, by focusing specifically on the largest companies and the most high-profile activist hedge funds, the study enables an evaluation of the actors that are most likely to have an outsized impact on stakeholders and society more generally. The dataset therefore makes a significant general contribution to understanding of activist hedge fund campaigns at large companies.

More specifically, it is also the first empirical study to provide an in-depth comparison of activist board representation campaigns with non-board level campaigns at S&P 500 companies, thus shedding light on what is now the most common form of hedge fund activism. At a more granular level, the specific findings from the data also contribute to the literature and to our understanding of activist hedge fund campaigns. The thesis demonstrates that activist campaigns for board representation manifest differently from activist campaigns that do not contain a request for board representation. First, in terms of investment horizon, the average duration of activist board representation campaigns is significantly longer than the average duration of non-board level campaigns. This permits an analysis of this form of hedge fund activism against the persistent narrative of

[6] *See infra* Chapter 4, Section I. A. 2; and John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, ANNALS OF CORP. GOVERNANCE 1, 54 (2016).
[7] *See infra* Chapter 4, Section I. A. 2; and BRIAN R. CHEFFINS, THE PUBLIC COMPANY TRANSFORMED 372 (2018).

short-termism. The capital commitment involved in such campaigns is also much larger. In terms of campaign objectives, it is uncommon for activist hedge funds to engage in strategic and operational activism without also requesting at least one board seat. There is a strong association between activist board representation and the activists seeking strategic and operational change. Activist hedge funds are also much more likely to campaign for, and succeed in, removing the CEO when they secure representation on a target company's board. Overall, an analysis of activist board representation campaigns contributes new evidence of activist hedge fund behavior that contradicts dominant narratives pertaining to hedge funds. Primarily, it shows that activist board representation campaigns tend to involve a longer-term approach to value creation through strategic and operational changes, rather than the short-term financial engineering that activist hedge funds are commonly criticized for.

This thesis also contributes to the literature through its examination of the role of the board in twenty-first century corporations. Prior work has generally focused on the threat that activist hedge funds pose to boards, however, there is a gap in the literature in terms of analyzing what boards can learn from activist hedge funds. The thesis puts forward the idea that the key issues for companies and their boards are now negative externalities and short-termism, rather than the traditional agency problems of stealing and shirking. Activist directors appointed by hedge funds can expose some of the inadequacies of the monitoring board in responding to these challenges and demonstrate a real example of an alternative model. Specifically, activist directors are proactive in sustainable value creation, rather than merely reactive. Such directors are better informed, have access to resources, and have the motivation to contribute to corporate strategy and operations. Therefore, they overcome many of the criticisms levelled at independent directors on the monitoring board. The key contribution is that there is much to learn from activist directors when reimagining the board.

The final key contribution of the thesis is to the literature on ESG investing and activism. The thesis builds upon the study of activist board representation in Part II to argue that activist hedge funds may be well positioned to play a unique role in ESG activism by nominating specialist climate directors to corporate boards. Activist hedge funds focus on firm-specific ESG activism in a manner that may appeal to, and mobilize, the sustainable

capitalism of global asset managers such as the Big Three. The thesis also contributes some initial thoughts on the motivations and incentives behind ESG hedge fund activism, thus providing insights into this rapidly evolving practice.

This thesis is organized as follows. Part I situates hedge fund activism and the role of the board in traditional and contemporary corporate governance debates. Chapter 1 examines the intellectual foundations underpinning the monitoring board as a response to the shareholder-manager agency problem and challenges its continued dominance in light of pressing societal challenges facing corporations. Chapter 2 critiques the narrative of short-termism that is prevalent in politics, the media, and corporate practice, which can obscure learning from the campaigns of activist hedge funds. Part II examines activist hedge fund board representation campaigns. Chapter 3 introduces this form of hedge fund activism and presents a theory and hypotheses on the potential value associated with this type of activism. Chapter 4 tests the hypotheses presented in the preceding chapter through an empirical study analyzing activist board representation campaigns at S&P 500 companies since 2010. Part III explores ESG activism. Chapter 5 develops a new account of sustainable capitalism using the building blocks of agency theory. It highlights the major shift to passive index investing and ESG investing and analyzes the monitoring shortfall on the part of global asset managers. Chapter 6 discusses ESG hedge fund activism and (building on the theory and the empirical study presented in Part II) proposes that activist hedge funds can play a unique role in a sustainable capitalism framework by nominating specialist directors with climate or energy transition expertise to corporate boards. Chapter 7 considers socially responsible activism and presents a theoretical framework of ESG hedge fund activism.

PART I – Hedge Fund Activism and the Role of the Board

Introduction

No analysis of hedge fund activism would be complete without a discussion of the shareholder-manager agency problem. Indeed, most literature on the topic of hedge fund activism squarely situates an evaluation of whether activist hedge funds are heroes or villains within the agency costs framework. This Part takes a different approach to the one traditionally followed. It begins by acknowledging the importance of the agency costs framework in discussions of good corporate governance and the analysis of hedge fund activism. However, rather than primarily focusing on how well hedge fund activism can mitigate the problems of managerial stealing and shirking, it then moves beyond agency costs. The key argument is that the major problems facing companies today are not stealing and shirking but rather issues that the agency costs framework tends to ignore entirely, primarily negative corporate externalities and the problem of short-termism. Those problems are the ones most omnipresent when considering the current environmental and social challenges that corporations and investors are increasingly expected to address.

Part I proceeds as follows. Chapter 1 begins by discussing agency costs and the intellectual foundations underpinning the independent monitoring board as a response to the shareholder-manager agency problem. It provides a critique of the monitoring board and independent directors in the context of assessing whether this model can persist despite escalating social challenges and heightened expectations on the board. It proceeds to consider whether the board needs to be re-imagined in this context. The crucial question here centers around what role we expect boards to play in twenty-first century firms. The key contribution to the literature is that activist directors appointed by hedge funds expose the deficiencies of the independent monitoring board and provide some insight into a potential alternative model. Directors appointed by hedge funds are likely to be much more proactive in terms of advancing and critiquing corporate strategy and operations, as opposed to taking a passive or reactive role primarily in crisis situations. Indeed, activist directors are an example of a model that solves some of the problems associated with the independent monitoring board, such as information asymmetry and access to resources. Despite this, negative narratives around hedge fund activism have largely obscured any

discussion on what could be learned from activist directors in order to improve the current board model. As activist directors become deeply involved in analysis of corporate strategy and operations, and more recently in ESG issues, it is questioned whether the independent monitoring board can persist in its current form. This then leads into a discussion on the most important challenges for corporations today. Due to shareholder and stakeholder pressure with regard to ESG issues, there is a new focus on negative externalities. It is generally no longer viewed as acceptable that corporations focus solely on profits and governments should address any negative externalities through separate legislation. Therefore, there are increasing expectations on the board to play a role in tackling ESG issues.

Chapter 2 focuses on short-termism which is the dominant negative narrative plaguing activist hedge funds. The persistent focus on activist hedge fund short-termism is one of the reasons for the lack of discussion on the potential benefits of activist directors. The preoccupation with short-termism obscures any analysis on whether directors appointed by hedge funds can contribute positively to sustainable value creation. This chapter discusses the power of this narrative, and why activist hedge funds have largely failed in countering this narrative with their own competing account of management excess and waste. It explores the common criticisms levelled at activist hedge funds, including the accusation that activists engage primarily in financial wizardry and balance sheet activism to the detriment of the long-term success of target companies. This links to the later discussion in Chapter 3 and the empirical study in Chapter 4 which assess whether certain types of activist strategies may be more long-term oriented than others.

Chapter 1 – Beyond Agency Theory: Re-imagining the Board

I. AGENCY COSTS

A. Agency Costs and Good Corporate Governance

Good corporate governance – and perhaps even the purpose of corporate law itself – is often equated to controlling or minimizing shareholder-manager agency costs.[8] Since the 1970s, the economic theory of agency problems has been immensely influential to the academic theory of corporate law and governance, as well as to its development in practice.

The ideas underpinning the shareholder-manager agency problem are not new. Two hundred years before the term "corporate governance" entered common parlance,[9] Adam Smith, in *The Wealth of Nations*, articulated the substance of the shareholder-manager agency problem:

> "The directors of such [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own…Negligence and profusion,

[8] John Armour, Henry Hansmann, Reinier Kraakman & Mariana Pargendler, *What is Corporate Law?*, *in* THE ANATOMY OF CORPORATE LAW 1, 2 (Reinier Kraakman et al. eds., 3rd ed. 2017) (describing the purpose of corporate law to be an attempt to control conflicts of interest or "agency problems" among corporate constituencies); Stephen M. Bainbridge, *Responses: Director Primacy and Shareholder Disempowerment* 119 HARV. L. REV. 1735, 1746 (2006) (noting that "much of corporate law is best understood as a mechanism for constraining agency costs."); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 248-49 (1999) (noting that "This principal-agent model..has given rise to two recurring themes in the literature: First, that the central economic problem addressed by corporation law is reducing "agency costs" by keeping directors and managers faithful to shareholders' interests; and second, that the primary goal of the public corporation is – or ought to be – maximizing shareholders' wealth"); Ronald J. Gilson, *From Corporate Law to Corporate Governance*, *in* OXFORD HANDBOOK OF CORPORATE GOVERNANCE, 4 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018) (noting that "The intellectual impact of the agency cost characterization is hard to overstate: for the last 40 years, the mission of American corporate law, and of corporate scholarship more broadly, has taken the form of a search for the organizational Holy Grail, a technique that bridges the separation of ownership and control by aligning the interests of shareholders and managers"); Dorothy S. Lund & Elizabeth Pollman, *The Corporate Governance Machine*, 121 COLUM. L. REV. 2563, 2566 (2021) (noting that ""good governance" is often equated with minimizing agency costs in the pursuit of shareholder value").

[9] See Brian R. Cheffins, *The History of Corporate Governance*, *in* OXFORD HANDBOOK OF CORPORATE GOVERNANCE, 46 (Mike Wright, Donald Siegel, Kevin Keasey & Igor Filatotchev eds., 2013) (noting that the phrase "corporate governance" only came into vogue in the 1970s in the United States and only acquired a strong international dimension in the 1990s). *See generally* Gilson, *supra* note 8, at 3-27.

> therefore, must always prevail, more or less, in the management of the affairs of such a company."[10]

The issue highlighted in Adam Smith's statement made in 1776 is still a concern in the present day. Shareholder-manager agency theory articulates the problem of managers behaving opportunistically when their interests diverge from shareholders' interests, resulting in losses to firm value. As the authors note in *The Anatomy of Corporate Law*:

> "an "agency problem" – in the most general sense of the term – arises whenever one party, termed the "principal", relies upon actions taken by another party, termed the "agent," which will affect the principal's welfare. The problem lies in motivating the agent to act in the principal's interest rather than simply in the agent's own interest."[11]

The resulting "agency costs" have traditionally been viewed as the central problem of Anglo-American systems of corporate law and governance and the focus has consistently been on finding mechanisms to mitigate the effects of this problem. Although multiple agency problems exist,[12] most attention has been paid to the problem of shareholder-manager agency costs. If managers (the "agents") fail to act in the best interests of the shareholders (the "principals"), this can result in losses to the shareholders who are the residual claimants in the corporation.

The shareholder-manager agency problem that has dominated corporate governance debates for decades is thought to arise from the separation of ownership and control in public companies with widely dispersed ownership. In *The Modern Corporation and Private Property*, published in 1932, Adolf Berle and Gardiner Means observed that the separation of ownership and control has the potential to lead to powerful managers being unconstrained by powerless shareholders, who are unable to effectively monitor

[10] ADAM SMITH, THE WEALTH OF NATIONS 700 (1776, Cannan Edition, Modern Library 1937).
[11] John Armour, Henry Hansmann & Reinier Kraakman, *Agency Problems and Legal Strategies*, *in* THE ANATOMY OF CORPORATE LAW 29 (Reinier Kraakman et al. eds., 3d ed. 2017).
[12] Armour, Hansmann, Kraakman & Pargendler, *supra* note 8, at 2 (noting that there are three principal agency problems: "conflicts between managers and shareholders, conflicts between controlling and non-controlling shareholders, and conflicts between shareholders and the corporation's other contractual counterparties, including particularly creditors and employees.")

managers.[13] This results in what Berle and Means referred to as "management control" of the corporation.[14]

Although Berle and Means discussed the separation of ownership and control in their classic work in 1932, it was only in the late 1970s and in the 1980s when this concept was fully incorporated into corporate law and governance scholarship and practice that it received much more attention.[15] The catalyst for this was the publication of an economics paper, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, by Michael Jensen and William Meckling in 1976.[16] In that article, Jensen and Meckling noted that "the issues associated with the "separation of ownership and control" in the modern diffuse ownership corporation [are] intimately associated with the general problem of agency".[17] From then on, "finance economists and law professors shifted their discussion from the "separation of ownership and control" – the phrase popularized by Berle and Means – to shareholder-manager "agency costs"".[18]

The economists Jensen and Meckling therefore formalized a theory of agency costs in public companies that essentially became the conventional economic theory of the firm. Overarchingly, they noted that "if both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal".[19] Jensen and Meckling defined agency costs as the sum of: (i) monitoring expenditures (costs incurred by shareholders to establish appropriate incentives for the managers and to ensure through monitoring that managers are acting in the best interests of the shareholders); (ii) bonding expenditures (costs incurred by managers to introduce

[13] *See generally* ADOLF A. BERLE AND GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV 520 (1990); Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923, 923 (1984) (noting that "discussion of the corporate form still invariably begins with Berle and Means' location of the separation of ownership and control as the master problem for research").
[14] Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPECTIVES 89, 91 (2017).
[15] Faith Stevelman & Sarah C. Haan, *Boards in Information Governance*, U. PA. J. BUS. L. 179, 187 (2020) [hereinafter *Information Governance*] (noting that "Though Berle and Means raised alarm about efficiency losses in widely-held firms back in the 1930s, it was only in the late 1970s and '80s that agency cost corporate governance began its hegemonic reign in corporate theory, law, and governance practice").
[16] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).
[17] Jensen & Meckling, *supra* note 16, at 309.
[18] Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1913 (2013).
[19] Jensen & Meckling, *supra* note 16, at 308-09.

mechanisms that aim to prevent managers from taking certain actions that would harm the shareholders or to ensure that shareholders will be compensated if managers do take such actions); and (iii) the residual loss (the reduction in welfare experienced by the shareholders due to the divergence between the managers' decisions and decisions which would maximize the welfare of the shareholders).[20]

Ultimately, these theories espoused the view that shareholders cannot rely upon the faithful performance of managers and therefore agency costs arise in public corporations. More specifically, agency costs can be manifested in the firm a number of different ways. The two main categories of shareholder-manager agency costs that are consistently repeated in the literature are shirking and stealing (or self-dealing), or as Frank Easterbrook and Daniel Fischel have more colloquially called this, "diversion and sloth".[21] On "shirking", Jensen and Meckling note that "it is likely that the most important conflict arises from the fact that as the manager's ownership claim falls, his incentive to devote significant effort to creative activities such as searching out new profitable ventures falls."[22]

On "self-dealing" or "stealing", Jensen and Meckling argue that the agency conflict "[derives] from the manager's tendency to appropriate perquisites out of the firm's resources for his own consumption".[23] Easterbrook and Fischel further add that "in the absence of control devices, the agent will have an incentive to siphon off profits, fritter away time, or otherwise further his own interest at the shareholders' expense".[24] They also outline some examples of the ways that managers can divert firm assets to themselves: "theft is the dramatic way to do this; diversion of "corporate opportunities" may be another, and in general the discretion managers possess gives them an opportunity division of interests will lead to less diligent work."[25] There are various

[20] Jensen & Meckling, *supra* note 16, at 308.
[21] Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 1 (1991).
[22] Jensen & Meckling, supra note 16, at, 313. See also John C. Coffee Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1155 (1984).
[23] Jensen & Meckling, *supra* note 16, at 313.
[24] Frank H. Easterbrook & Daniel R. Fischel, *Takeover Bids, Defensive Tactics and Shareholders' Welfare*, 36 BUS. L. 1733, 1735-36 (1981) (it was also noted at the time that it was "futile to expect shareholders to perform this task of monitoring. The tender offeror, like the shareholder waging a proxy contest, serves as a monitor of the corporation's agents.").
[25] EASTERBROOK & FISCHEL, *supra* note 21, at 10. On theft, *see* Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 742 (1997) (noting that "much of the corporate law development in the 18th and 19th centuries in Britain, Continental Europe, and Russia focused precisely on addressing the problem of managerial theft rather than that of shirking or even empire-building.").

ways that managers could serve their own interest, including perks such as "plush carpets and company airplanes".[26]

Another manifestation of the agency problem that is commonly highlighted is "empire building", as managers may have an incentive to cause their firms to grow beyond the optimal or rational size.[27] Empire building could arise if managers engage in inefficient levels of corporate acquisitions in order to promote their own status and prestige. Additionally, as executive compensation is likely to increase commensurate to the size of the enterprise, managers have a further financial incentive to continue to grow their firms beyond an efficient level.[28]

Jensen also argued that managers have an incentive to retain excessive amounts of "free cash flow", defined as cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital.[29] Such an approach is seen as detrimental to diversified shareholders and a strategy to "insulate managers from the market discipline resulting from the need to attract investment in new issuances in equity".[30]

Finally, managers can seek to entrench themselves in their corporate positions (regardless of competence), or increase their own compensation.[31] Indeed, Jensen and Ruback argued that "poor managers who resist being replaced might be the costliest manifestation of the agency problem."[32] The ability of managers to use their positions to benefit themselves rather than investors are also often described as the "private benefits of control".[33]

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[26] Shleifer & Vishny, *supra* note 25, at 742, citing BRYAN BURROUGH & JOHN HEYLAR, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO (1990).
[27] Michael C. Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, 76 AM. ECON. REV. 323, 323 (1976).
[28] Rock, *supra* note 18, at 1914, citing Jensen, *supra* note 27 at 323 (noting that "[b]ecause managers of large enterprises are better compensated than managers of smaller enterprises, managers have a private incentive to expand – even when doing so is not justified by the returns to shareholders.")
[29] Jensen, *supra* note 27, at 323.
[30] Rock, *supra* note 18, at 1914, citing Jensen, *supra* note 27, at 323.
[31] EASTERBROOK & FISCHEL, *supra* note 25, at 217-18 (noting that "managers may elect to behave opportunistically – to maintain themselves in office or raise their compensation at the expense of investors.")
[32] Shleifer & Vishny, *supra* note 25, at 742-43, citing Michael Jensen and Richard Ruback, *The market for corporate control: The scientific evidence*, 98 J. POL. ECON. 225-263 (1990).
[33] Shleifer & Vishny, *supra* note 25, at 742.

Lucian Bebchuk more recently summarizes the agency costs potentially caused by full-time executives managing a company as "an incentive to engage in empire-building, take excessive compensation, enjoy excessive perks, pursue pet projects, elevate cronies, refuse to accept beneficial acquisition offers, remain in power too long, and so forth".[34]

One major factor at play that may enable managers to act in their own interest rather than in the interests of shareholders is information asymmetry. In *The Anatomy of Corporate Law*, the authors highlight the core problem of information asymmetry in the following terms:

> "because the agent commonly has better information than does the principal about the relevant facts, the principal cannot easily assure himself that the agent's performance is precisely what was promised. As a consequence, the agent has an incentive to act opportunistically, skimping on the quality of his performance, or even diverting to himself some of what was promised to the principal. This means, in turn, that the value of the agent's performance to the principal will be reduced, either directly or because, to assure the quality of the agent's performance, the principal must engage in costly monitoring of the agent."[35]

Managers have an "important informational advantage" over shareholders, so it can be difficult for shareholders (as the principals) to attain reliable information on managerial behavior.[36] It is the managers who will always have access to the inside information regarding how the business is actually running day-to-day and this information could potentially be concealed from investors or presented in a misleading way. This asymmetry of information could serve to enable managers "armed with private knowledge and able to keep investors in the dark" to "divert income to themselves, stealing and mismanaging at the same time."[37]

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[34] Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 679 (2007).
[35] Armour, Hansmann & Kraakman, *supra* note 11, at 29. *See also* OLIVER WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 47-49 (1985) (noting that the term "opportunism" is used to refer to self-interested behaviour that involves some element of guile, deception, misrepresentation, or bad faith).
[36] Ian Ayres & Peter Cramton, *Relational Investing and Agency Theory*, 15 CARDOZO L. REV. 1033, 1039 (1994), citing PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION, AND MANAGEMENT 496 (1992).
[37] EASTERBROOK & FISCHEL, *supra* note 21, at 1.

In an effort to mitigate agency costs, there are a number of mechanisms that have developed to align the interests of managers and shareholders. One key example is an independent board of directors acting as a monitor of management, as discussed later in Section II below. Before discussing one of the key solutions, and its relevance to hedge fund activism, Section B below discusses the limitations of agency theory as a framework.

B. Beyond Agency Costs

1. Criticisms of Agency Theory

Over the years since the study of shareholder-manager agency costs became prevalent in corporate law and governance, there has been alternative scholarship that criticizes the orthodox agency approach. A notable and prominent example is Margaret Blair and Lynn Stout's work on team production and the mediating hierarchy approach. Here, Blair and Stout "take issue with both the prevailing principal-agent model of the public corporation and the shareholder wealth maximization goal that underpins it."[38] Stephen Bainbridge also notes that "[a]gency cost analysis thus applies only imperfectly to the modern public corporation."[39] He explains that as corporate law could successfully eliminate agency costs by removing board discretion, this leads to the conclusion that accountability is not the only norm valued in corporate law. As a result, he puts forward a theory of director primacy whereby he argues that corporate law values both authority and accountability.[40]

However, even those who critique traditional agency theory still acknowledge to varying extents the existence of agency costs in some form and the potential for managers to shirk and self-deal. For example, in Blair and Stout's theory of team production, it is noted that shirking and rent-seeking can erode or even destroy the gains from team production, so it is in the collective interest of the team members to minimise such behavior.[41] Moreover, despite Stout's criticism of the "obsessive" focus of modern corporate scholarship on the managerial agency costs problem, she still accepted that "given the weakness of human nature, it is only to be expected that corporate agents – in particular corporate directors

[38] Blair & Stout, *supra* note 8, 249.
[39] Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 568 (2003) (noting also that "To be clear, the claim is not that agency cost models are irrelevant to understanding the public corporation. Rather, the claim is only that such models are incomplete.")
[40] Bainbridge, *supra* note 39, at 568,
[41] Blair & Stout, *supra* note 8, at 271.

and executives – sometimes seek to serve their own interests rather than the entity's objectives". She also acknowledges "inevitable sources of managerial agency costs".[42] Bainbridge also notes that "given human nature…it would be surprising indeed if directors did not sometimes shirk or self-deal."[43] Therefore, the existence of agency problems and the nature of the problems is generally accepted, even by critics, even though the full practical extent of the problem may be vigorously debated.

Other critiques of agency theory include that it is overly pessimistic in terms of its assessment of corporate managers and that agency problems have largely been solved and is no longer relevant in modern corporations. On the first point, when articulating the early theories, Easterbrook and Fischel themselves insisted that they did not mean to suggest that "most companies have lazy and venal management", stressing that "[o]ur point, rather, is that managers, like other employees, respond to incentives."[44] Yet, the focus of agency theory on self-dealing and shirking has still been argued to reflect an overly harsh and pessimistic view of corporate managers. For example, Martin Lipton and William Savitt argue strongly against the theory, noting that "we believe that this "agency cost" account of director conduct is pure myth", lamenting that "the agency model simply assumes that directors are scoundrels" and criticizing that "venal, self-interested directors are assumed to be the norm." They also go so far as to say that in any other context such an accusation against seasoned professionals "might well be regarded as slanderous".[45] Instead, they argue that "[t]he self-interested director conjured by the agency theory bears no resemblance to the vast majority of faithful fiduciaries who actually serve on the boards of U.S. public companies."[46] In the same vein, Bengt Holmström notes that "[i]n my experience, board members have much more integrity and are more thoughtful than many believe"[47] and George Dent posits that "self-serving behavior does not necessarily stem from venality".[48] Similarly, Leo Strine has referred to "actual human tendencies", which could include "a propensity to rationalize compromises of conscience when that is

[42] Lynn A. Stout, *The Corporation As Time Machine: Intergenerational Equity, Intergenerational Efficiency, and the Corporate Form*, 38 SEATTLE U. L. REV. 685, 705-706 (2015).
[43] Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1, 22 (2006).
[44] Frank H. Easterbrook & Daniel R. Fischel, *Takeover Bids, Defensive Tactics and Shareholders' Welfare*, 36 BUS. L. 1733, 1735-36 (1981).
[45] Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk* 93 VA. L. REV. 733, 750 (1999).
[46] Lipton & Savitt, *supra* note 45, at 752.
[47] Bengt Holmström, *Pay without Performance and the Managerial Power Hypothesis: A Comment*, 30 J. CORP. L. 703, 705 (2005), cited in Lipton & Savitt, *supra* note 45, at 750.
[48] George W. Dent Jr., *Corporate Governance: Still Broke, No Fix in Sight* 31 J. CORP. L. 39, 47 (2006).

necessary to protect one's own hide." Here, he quotes a case from the Delaware Court of Chancery, which noted that: "Human nature may incline even one acting in subjective good faith to rationalize as right that which is merely personally beneficial".[49] Gerald Davis also argues that agency theory "fails to consider the broader intercorporate environment in which management acts" and that it "implicitly relies on an atomistic or undersocialized view of managerial action as largely divorced from social context" whereas "decades of theory and behavioral research on organizations demonstrate the power of the social context to shape organizational and managerial action".[50] Therefore, there are clearly broader considerations and cognitive biases that may affect the behavior of manager, as opposed to this always simply being an issue of outright stealing or shirking.

2. Has the Shareholder-Manager Agency Problem Been Solved?

Some scholars have argued that the shareholder-manager agency problem that has been discussed so widely in the literature may in fact have been solved already. In 2013, Edward Rock posed the question "what remains of the classic shareholder-manager agency problem?", arguing that "the core shareholder-manager agency cost problem now seems largely under control (even if there will always be outliers)." Perhaps the key takeaway from this argument[51] is that the traditional conceptions of stealing and shirking – while they may occur in isolated cases – should not necessarily continue to be the primary concern of corporate law and governance. Over recent decades, various mechanisms have been implemented to address or reduce shareholder-manager agency costs, and Rock argues that these measures – such as executive compensation, board reforms, the transition from dispersed to more concentrated shareholdings, and increased levels of shareholder opposition to management – have resulted in the shareholder-manager agency cost problem largely being brought under control.[52]

[49] Leo E. Strine Jr., *Making It Easier for Directors to Do the Right Thing*, 4 HARV. BUS. L. R. 235, 240-241 (2014) (citing City Capital Associates Ltd Partnership v Interco Inc 551 A.2d 787, 796 (Del Ch 1988)).
[50] Gerald F. Davis, Ag*ents without Principles? The Spread of the Poison Pill through the Intercorporate Network*, 36 ADMIN. SCI. Q. 583, 591 (1991).
[51] This was not Rock's takeaway as his article was focused on the other agency problems and particularly the position of creditors. *See* Rock, *supra* note 18, at 1927 (noting that "in our preoccupation with the classic "separation of ownership and control" or, more recently, the "shareholder-manager agency cost problem," we seem to have forgotten what other corporate law systems have not: that there are *three* corporate law agency cost problems, not one.")
[52] Rock, *supra* note 18, at 1921.

Two illustrations of specific problems that may be less pronounced today are the free cash flow problem and managerial empire-building. Rock argues that the "free cash flow problem" that was prominent in the classic agency costs literature "has largely disappeared".[53] He argues similarly regarding the decline managerial empire building, noting that the "explosion of deconglomeration" in the 1980s means that this is no longer a relevant issue.[54] In particular, a return to specialization rather than generalization meant that large conglomerate entities have been broken into pieces by hostile or friendly takeovers, or through spin-offs.[55] John Coffee and Darius Palia similarly argue that assumptions about managerial empire building are out of date.[56]

While it would be going too far to proclaim that shareholder-manager agency problems no longer exist and have been solved in their entirety, it seems reasonable to attest that the issues of stealing and shirking are no longer the most prominent or pressing issues affecting most corporations. Of course, there will always be (often high-profile) exceptions. However, it is argued here that although managerial agency problems are still important – and certainly important in terms of hedge fund activism being one potentially effective mechanism to mitigate such problems – the issues that may be top of mind in the twenty-first century for companies, their boards and executive teams and indeed for corporate critics are exactly those that the agency costs model ignores entirely. These include negative externalities from corporate behavior and short-termism – problems that are of major concern to a broad range of stakeholders and that are firmly on the modern current corporate law and governance agenda. Negative externalities are discussed in Section IV below, and short-termism in Chapter 2.

However, before considering in more depth these pressing new corporate governance problems that did not form part of traditional agency cost theory, Section II below considers the role of the monitoring board as a solution to reducing shareholder-manager agency problems and critiques its continued dominance in the present day. As we will see,

[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] John C. Coffee Jr., & Darius Palia, *The Wolf at The Door: The Impact of Hedge Fund Activism on Corporate Governance* 41 J. CORP. L. 545, 550 (2016) (noting that "We think this assumption that managements typically engage in inefficient empire-building is today out of date and ignores the impact of major changes in executive compensation.")

the role of the board of directors in corporations already evolved quite dramatically due to the intense focus on agency theory and shareholder wealth maximization. However, the current board model of a monitoring board comprised of independent directors may be deficient to address the most pressing issues in contemporary corporate law and governance, in particular the climate crisis and other environmental and social issues. In fact, the monitoring board as a solution to the shareholder-manager agency problem in some respects creates additional problems over and above the agency problem that it was intended to solve. As explored further in Section III below and in Chapter 4, modern hedge fund activism has vividly exposed many of the shortcomings of the monitoring board – particularly in terms of its lack of attention to substantive value creation and the importance of board capability with respect to ESG issues. Activist board representation (the focus of Chapters 3 and 4) also presents itself as a solution that not only mitigates traditional agency problems but also goes further in terms of addressing the most important issues facing corporations, their boards, and their managers today. The study of activist board representation campaigns can be particularly helpful in terms of thinking about how boards must continue to evolve in order to address these pressing societal challenges and meet the expectations of company shareholders and other stakeholders.

II. THE MONITORING BOARD

A. From the Advisory Board to the Monitoring Board: A Focus on Agency Costs

It has been widely accepted that the role of boards of directors is to reduce agency costs associated with the separation of ownership and control.[57] Indeed, the principal corporate governance response to the shareholder-manager agency problem is the independent director.[58] However, independent directors were not always a core component of corporate boards, and the board's role was not always seen as "monitoring". Major changes to the composition and function of the board of directors have taken place since the 1950s and 60s.[59] In terms of board *composition*, inside directors were historically dominant and held

[57] 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, 1468 (2007) [hereinafter *The Rise of Independent Directors*].
[58] Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV 127, 137 (2010), citing Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73, 81 (2007).
[59] Gordon, *The Rise of Independent Directors*, *supra* note 57, at 1472-73 (noting that "One of the most important empirical developments in U.S. corporate governance over the past half century has been the shift in board composition from insider (and affiliated directors) toward independent directors.")

most seats on corporate boards.[60] More recently, inside directors have been almost entirely eclipsed by outside, independent directors. By the 1990s, the presence of independent directors on the board became increasingly prevalent and towards the end of the global financial crisis, half of S&P 500 companies only had one inside director on the board – the CEO.[61] This pattern remains in place today, with the CEO most often being the "lone company insider" in the majority of S&P 500 companies.[62] In the U.S., the percentage of public company directors who are independent has grown to 86% in 2021.[63] The U.K. similarly has a high percentage of independent directors, at 72%.[64]

Similarly, with respect to board *function*, there was a clear shift from the board *advising* the CEO to a focus on the board's role as a *monitor* of management. This great transition led Stephen Bainbridge and Todd Henderson to observe that "[m]onitoring management today is not just *a* board function; arguably it is *the* board's function."[65] This dramatic evolution from the advisory board composed of insiders to the monitoring board made up of independent directors evolved in parallel with both to the agency cost framework that grew in prominence from the 1970s onwards, and the principle of shareholder wealth maximization.[66]

1. The Advisory Board

Jeffrey Gordon charts the evolution of the board from the "advising board" of the post-World War II era to the "monitoring board", where director independence became increasingly commonplace.[67] During managerialism in the 1950s, directors were a core part of the CEO's team. This close-knit group of confidants was made up of insiders who were also corporate officers or "affiliated" directors who were often linked to the

[60] Fairfax, *supra* note 58, at 135.
[61] Fairfax, *supra* note 58, at 135-36.
[62] SPENCER STUART, 2014 SPENCER STUART BOARD INDEX, at 8 (2014), http://www.spencerstuart.com/research/articles/1621/ (noting that in fifty-nine percent of the S&P 500 companies the CEO is the only company employee in the boardroom, cited in Kastiel & Nili, *supra* note 18, at 26-27.
[63] SPENCER STUART, 2021 UK SPENCER STUART BOARD INDEX https://www.spencerstuart.com/research-and-insight/boards-around-the-world?category=all-board-composition&topic=independent-directors.
[64] *Id.*
[65] STEPHEN M. BAINBRIDGE & M. TODD HENDERSON, OUTSOURCING THE BOARD 42 (2018).
[66] Gordon, *The Rise of Independent Directors*, *supra* note 57, at 1468 (noting that "Director independence became linked to the monitoring of managerial performance in order to serve shareholder ends.")
[67] Gordon, *The Rise of Independent Directors*, *supra* note 57, at 1468 and 1510-1540.

company's law firm, bank or investment bank, as well as others who the CEO trusted.[68] Here, "the CEO's trust in the board was critical,"[69] in contrast to the current monitoring model where the situation is theoretically reversed as the board's trust in the CEO becomes much more important. Therefore, boards at this time had "a cozy relationship with the company C-suite."[70]

This, however, posed a problem for managerial accountability. The growing recognition of the limitations of the advisory board model led to pressure to move from an advisory model to a monitoring model.[71] Notably, the monitoring board has its origin in academic theories from the 1970s that later gained widespread acceptance in practice.[72] In particular, it was forcefully argued by Melvin Eisenberg in his 1976 book, *The Structure of the Corporation: A Legal Analysis*, that it was imperative that the board transition from mere "pawns" of management to effective monitors of management.[73] The advisory board began to lose its popularity due to various corporate scandals in the 1970s which led to increased scrutiny of the model's ability to prevent managerial malfeasance.[74] The stark practical realities of the advisory board's inability to contain managerial agency costs – as demonstrated through corporate scandals – then bolstered the position taken in the the academic literature. Essentially, the advisory board was criticized as "simply providing managers with the appearance of accountability, rather than the reality".[75]

The result, as Lisa Fairfax has noted, is that the inside director is now "a dying breed" that "has become almost obsolete".[76] Although they once dominated corporate boards, "today

[68] Ronald J. Gilson & Jeffrey N. Gordon, *Board 3.0: An Introduction*, 74 BUS. LAW. 351, 355 (2019) [hereinafter *Board 3.0: An Introduction*].
[69] Gordon, *The Rise of Independent Directors*, *supra* note 57, at 1511.
[70] Faith Stevelman & Sarah C. Haan, *Board Governance for the Twenty-First Century*, 74 BUS. LAW. 329, 329 (2019) [hereinafter *Board Governance*].
[71] Gordon, *The Rise of Independent Directors*, *supra* note 57, at 1514-15.
[72] Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 354 (noting that "[t]he current board model for public companies has its genesis in academic theorizing in the 1970s that subsequently found acceptance among the elite corporate bar and Delaware courts").
[73] Gordon, *The Rise of Independent Directors*, *supra* note 57, at 1478 and 1518; Mariana Pargendler, *The Corporate Governance Obsession*, 42 J. CORP. L. 359, 375 (2016), citing MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 162-70 (1976).
[74] Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 355.
[75] Key examples of such literature are MYLES L. MACE, DIRECTORS: MYTH AND REALITY (1971) (which "exposed the pervasiveness of director passivity and underscored the failure of the advisory board model") and EISENBERG, *supra* note 73 ("identifying corporate failures of early 1970s as evidence of the failure of the advising board model") both cited in Gordon, *The Rise of Independent Directors*, *supra* note 57, at 1516.
[76] Fairfax, *supra* note 58, at 130.

the inside director has been painted as biased, untrustworthy, and generally antithetical to the best interests of shareholders and the corporation."[77]

2. The Monitoring Board and Independent Directors

The focus on the monitoring board and the related growth in prominence of independent directors is a relatively recent development that took place in parallel with the development of the economic theory of agency costs described above and the principle of shareholder wealth maximization. As the agency problem gained increasing recognition, solutions had to be identified to align the interests of shareholders with the interests of managers. The primary solution to that problem – that eventually became palatable to incumbent managerial elites – was the independent monitoring board.[78]

The principal function of an independent board is to monitor managers with the goal of ensuring that they do not abuse their positions in the ways described in Section I above, such as by stealing or shirking.[79] The idea is that as independent directors are "not economically beholden to the corporation and therefore not under the economic thumb of the CEO",[80] they are in a better position to objectively monitor management. Acceptance of this principle prompted a "dramatic evolution of the corporate board – from a homogenous insider-dominated club to a diverse and independent body".[81] Indeed, the monitoring board populated by independent directors was trumpeted as "the perfect response to the corporate-agency problem".[82]

Academic theories proposing increased use of independent directors were also bolstered by contemporaneous events. Corporate scandals that unfolded in the 1970s and 1980s led to increased calls for monitoring and corporate governance safeguards, and thus demand for independent directors intensified. Jeffrey Gordon has noted that the "well-publicized business failures of the period led to increasing acceptance of the "monitoring model" of

[77] Fairfax, *supra* note 58, at 130-31.
[78] Laura Lin, *The Effectiveness of Outside Directors As a Corporate Governance Mechanism: Theories and Evidence*, 90 Nw. U. L. Rev 898, 900 (1996) (noting that "This focus on the board of directors is part of on-going research on ways to align the interests of management and residual risk-bearing shareholders.")
[79] Fairfax, *supra* note 58, at 137 (noting that the role of independent directors is "ensuring that managers do not abuse their authority by engaging in self-dealing or fraud, or otherwise shirking their responsibilities").
[80] Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 354.
[81] Jill E. Fisch, *Corporate Governance: Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 265 (1997).
[82] Fairfax, *supra* note 58, at 137.

the board which required independent directors".[83] Fairfax outlines that this resulted in the "virtual elimination of inside directors' role on corporate boards", as there was an "overwhelming consensus that boards should be dominated by "independent" directors".[84]

However, of course a monitoring board was technically a threat to management control of the corporation, so why was this new governance structure eventually embraced rather than rejected by incumbent managers? Gordon has described the key role that the 1980s deal decade and hostile takeover movement played in independent directors ultimately becoming a palatable solution for the managerial elites who held power in corporations. Although managers had originally "vigorously resisted" a move to the independent monitoring board, the fact that such a governance structure could "serve as a buffer from the hostile takeover and as a substitute for greater government intervention in the wake of scandals"[85] proved to be crucial in the transformation of the monitoring board from an academic theory to a practical reality.

During the 1980s hostile takeover wave, the emphasis was very clearly on shareholder wealth maximization, in ways that were unprecedented in corporate America. As well as being a response to the deficiencies that were brought to light by corporate scandals, an independent monitoring board was effectively endorsed by the Delaware courts as a mechanism to defend against a hostile takeover.[86] In two pivotal takeover cases – *Unocal Corp. v Mesa Petroleum Co.*[87] and *Moran v. Household International, Inc.*"[88] board independence was identified as a crucial precondition to defensive measures being properly invoked. Moreover, in *Paramount Communications, Inc. v. Time, Inc.,*[89] the Delaware Supreme Court went even further by permitting boards of directors to "just say

[83] Gordon, *The Rise of Independent Directors*, *supra* note 57, at 1478.
[84] Fairfax, *supra* note 58, at 131.
[85] Gordon, *The Rise of Independent Directors*, *supra* note 57, at 1472.
[86] Gordon, *The Rise of Independent Directors*, *supra* note 57, at 1522 (noting that "Managers turned to the monitoring board and to independent directors as the best available protection against the hostile takeover movement, despite the encroachment on managerial autonomy.")
[87] 493 A.2d 946 (Del. 1985).
[88] 500 A.2d 1346 (Del. 1985), both cited in Gordon, *The Rise of Independent Directors*, *supra* note 57, at 1524.
[89] 571 A.2d 1140 (Del. 1990).

no" to hostile takeovers, so long as there was a majority of independent directors on the board who exercised their independent judgment.[90]

The result was that "[b]y the end of the decade managerial elites were aggressively promoting the virtues of the monitoring board, since a robust board seemed to offer a safe harbor against the pressure of the takeover movement."[91] In sum, as Gordon notes, "director independence came to be understood as a critical element in the intellectual and legal architecture necessary to preserve managerial autonomy against the pressure of the market for corporate control. A managerial elite that in prior decades had no use for independent directors now embraced them as an essential element of shareholder capitalism."[92]

The monitoring board populated with independent directors remains dominant in Anglo-American corporate governance until the present day. However, it is not immune from criticism. The monitoring board did not fully solve the shareholder-manager agency problem as was hoped, and it also potentially generated new problems that did not arise with advisory boards populated by insiders.

B. Critiques of the Monitoring Board and Independent Directors

As illustrated in the preceding section, the independent monitoring board is firmly ingrained in the corporate governance of public corporations and is viewed as a means of mitigating shareholder-manager agency problems. The transformation has been so fundamental that Margaret Blair and Lynn Stout went as far as to say that "an independent board is what makes a public corporation a public corporation".[93] There are, however, considerable shortcomings associated with the monitoring board, both in terms of its composition and its function. Back in the early 1990s, Ronald Gilson and Reinier Kraakman argued that "the traditional corporate solution of introducing outside directors to bridge the separation between ownership and control has dramatic limitations."[94] That

[90] Gordon, *The Rise of Independent Directors*, *supra* note 57, at 1525-26; Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 356.
[91] Gordon, *The Rise of Independent Directors*, *supra* note 57, at 1520-21.
[92] Gordon, *The Rise of Independent Directors*, *supra* note 57, at 1526.
[93] Blair & Stout, *supra* note 8, at 251.
[94] Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 876 (1991).

statement is even more true today, given the increased demands on boards of directors. Therefore, it may be shortsighted to assume that the monitoring board will persist indefinitely despite escalating societal challenges and the associated heightened expectations on corporations and their management teams.

There are strong critiques of the independent monitoring board, even from commentators who advocate for the centrality of the board of directors in corporate governance. The common thread running through the various critiques is that there are major limitations to the ability of the independent board to monitor effectively and there are no easy solutions to overcome the multitude of problems.[95] Therefore, the assumption that the independent monitoring board provides an ideal solution to the shareholder-manager agency problem is highly in doubt.

Critics address both board function and board composition. In terms of the composition of the board, independent directors are not corporate executives employed by the organization. While this may be theoretically a positive factor in terms of promoting objectivity and thus impartial monitoring, independent directors do not always prove to be effective monitors in practice. Additionally, when turning attention to board function, it is increasingly accepted that more is expected from boards than monitoring. Unfortunately, as a result of the shift from the advisory board to the monitoring board, important board functions such as strategic analysis and management have largely been forgotten.

1. Part-Time Monitors

The monitoring board is mostly comprised of part-time independent directors.[96] The rationale for independent directors is simple – these directors do not (formally at least) have connections to management and so can objectively monitor management to ensure that the company is run in the best interests of shareholders. One major drawback of

[95] Fairfax, *supra* note 58, at 132 (noting that "there exists significant limitations on independent directors' ability to fulfil their monitoring role, and it is very difficult to overcome those limitations, especially as independent directors' responsibilities increase").
[96] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 2, 116 Stat. 745, 751 (codified at 15 U.S.C. § 7220 (2012)); John Armour, Brandon Garrett, Jeffrey Gordon & Geeyoung Min, *Board Compliance*, 104 MINN. L. R. 1191, 1221 (2020) (noting that "to be classed as "independent," a director must not have an employment relationship with their company, meaning that they are of necessity a part-timer").

independent directors is the part-time nature of their appointments. Time is a finite resource and as independent directors are most often executives at other major companies, they have a full-time demanding position elsewhere. This severely limits the level of time and attention they can invest in their role as an independent director, especially if they hold multiple board appointments. Independent directors will receive papers before each board meeting, which are often read under significant time pressure given their other professional commitments. Additionally, outside of formal board meetings, board members ordinarily would not engage with the company or its management on a regular basis. They certainly would not be familiar with the issues arising from the day-to-day running of the company. Indeed, outside directors are unlikely to commit more than a few hours each month to their role as an independent director.[97] As a result, "boards sometimes fail to see or understand major business risks."[98] Given the extensive challenges facing modern day corporations, the increased expectations of shareholders, and the risk of challenges from activists, it is questionable whether such a part-time model can persist indefinitely. In this vein, Faith Stevelman and Sarah Haan argue that "[p]artial attentiveness is untenable as a norm of public company board service".[99]

2. Information Asymmetry and Lack of Resources

Gilson and Gordon describe independent directors as "thinly informed", "underresourced" and "boundedly motivated".[100] Informational problems can run both ways. The conventional critique is "to blame dysfunction on information shortcomings between independent directors and inside managers".[101] However, Bainbridge and Henderson note that "[a]t other corporations…an "indigestible overload of information" is dumped on directors".[102] Either way, the transition from the advisory board populated by insiders to the monitoring board populated by independent directors involves what Kobi Kastiel and Yaron Nili describe as the problem of "informational capture", where

[97] Kobi Kastiel & Yaron Nili, "Captured Boards": The Rise of "Super Directors" and the Case for a Board Suite, WIS. L. REV. 19, 28 (2017).
[98] Stevelman & Haan, *Board Governance*, *supra* note 70, at 331.
[99] *Id*.
[100] Ronald J. Gilson & Jeffrey N. Gordon, *Board 3.0: What the Private-Equity Governance Model Can Offer to Public Companies*, 32 J. APPLIED CORP. FIN. 1, 2 (2020) [hereinafter *Board 3.0: Private-Equity Governance*].
[101] BAINBRIDGE & HENDERSON, *supra* note 65, at 68, citing Michael P. Dooley & E. Norman Veasy, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 533 (1989).
[102] BAINBRIDGE & HENDERSON, *supra* note 65, at 68, citing RALPH D. WARD, SAVING THE CORPORATE BOARD: WHY BOARDS FAIL AND HOW TO FIX THEM, 1 (2003).

"outside directors lack the time, adequate resources, and the industry-specific knowledge to properly obtain, digest, and analyze the extensive and complex information that modern boards are tasked with evaluating."[103]

By virtue of their outsider status, independent directors are unlikely to have direct access to information about the company, so are heavily dependent on corporate managers for information.[104] When the CEO and other managers control the information that independent directors would require to act as effective monitors, this dependence has the potential to eradicate any benefits of an independent monitor of managerial misfeasance. Managers could conceivably conceal detrimental information from the board or present information in a misleading or selective manner.[105] Part-time independent directors are unlikely to seek out ways to independently obtain impartial information on corporate performance or to fully assess the accuracy of the information that they do receive. Therefore, the information they receive will always be filtered through management – the very individuals who they are tasked with monitoring. An information asymmetry problem therefore arises whereby corporate managers are much better informed than the independent board that is tasked with monitoring their behavior. It is difficult to conceive how such a board could ensure effective monitoring in such a situation, as managers ultimately have control over the information that is released to the monitoring board. This informational problem is perhaps the most fundamental flaw of the present board model. Gilson and Gordon similarly argue that "[i]n light of the time constraints of this decidedly part-time directorship model and the lack of an alternative information channel, [independent directors] are "thinly informed"".[106]

A related problem to the necessary reliance of independent directors on management for information is their lack of resources to critically analyze the information they actually do receive. Kastiel and Nili note that "outside directors suffer from information overload and

[103] Kastiel & Nili, *supra* note 97, at 23.
[104] Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 1.
[105] Kastiel & Nili, *supra* note 97, at 23 (noting that "independent directors are too dependent on the information management chooses to provide or conceal, as well as on the manner management presents it to the board") and at 28 (noting that "When screening the information for the board, company insiders may focus on information that supports their position and ignore information that undermines it. Insiders could also intentionally provide outside directors with limited information, or even manipulate the data presented to the board.")
[106] Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 356-57; Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 5.

they often lack the appropriate resources to properly process and analyze the voluminous information they are often presented within a timely manner"[107] Therefore, even if independent directors are accomplished and well intentioned, they can still fail to effectively monitor management due to the dual problems of information asymmetry and a lack of resources to assess such information.

As a result of the informational capture of the monitoring board, they tend to heavily rely on stock prices as a primary source of information. Gilson and Gordon note that "the firm's stock price performance, both year-to-year and in comparison to peers, has become the key metric for [monitoring board] directors, not only because it corresponds to some idea of shareholder welfare but because it provides a thinly-informed director with her or his most reliable measure of management's success".[108] However, the information that a simple stock price conveys "may be too general to surmount its informational disadvantage".[109] Consequently, there is a "recurrent pattern in which boards composed of talented and successful people fail to monitor effectively the corporate managements they are charged with overseeing."[110]

Overall, what can ultimately materialize is a bizarre situation where outside analysts may actually be better informed about the specific company than the independent monitoring board itself. Therefore, rather than the board solving the problems of information asymmetry identified in agency theory, the problem can be reversed whereby it is the board that is less well informed than an outsider who has the time and resources to devote to properly researching the company and its activities.[111] Here, the limitations of the monitoring board can be exposed very clearly by hedge fund activism. As activist hedge funds invest significant time and resources in analyzing the strategy and operations of companies they target, the incumbent board may be less well informed about the company than an activist hedge fund.

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[107] Kastiel & Nili, *supra* note 97, at 28.
[108] Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 356-57; Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 5.
[109] Fairfax, *supra* note 58, at 164.
[110] Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 1.
[111] Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 357; Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 5 (noting that "directors know that there is much they do not know, and they also know that management is in control of the information flow to the board. Directors also know that outsiders, including analysts, may well know more, and indeed have thought more, about the firm's economic performance/prospects".)

3. The Knowledge and Expertise Deficit

Another major problem with the independent monitoring board is what Fairfax labels "the knowledge deficit".[112] Independent directors usually have general business knowledge, but they often do not have the industry-specific expertise that is relevant to the companies whose boards they sit on in addition to their primary executive role. As well as lacking industry expertise, independent directors are even less likely to have deep firm-specific knowledge of the actual company on whose board they sit. Therefore, unlike their predecessor insider directors – who "had both the intimate familiarity with the corporation and the time to devote to effective management of corporate affairs,"[113] it is difficult for independent directors to attempt to replicate the type of "deep-dive" discussions on business and strategy that might come easily to an advisory board.[114] Amassing firm-specific knowledge would involve a significant investment in time and independent directors are unlikely to commit to such an endeavor.[115] Therefore, compared to the insider directors on the old-style advisory board, independent directors may lack both knowledge of the particular company and expertise in the relevant industry. Fairfax argues that "[t]his knowledge deficit is troubling…a monitoring system that relies on people without sufficient knowledge is not only inefficient, but potentially damaging."[116] This intuition is borne out in corporate governance scandals where it has become clear that effective monitoring by the board is often lacking.

The knowledge and expertise deficit makes the problem of directors lacking information and resources to analyze information even more troublesome. If independent directors do not understand the specific company or its industry, this raises doubt over how adept such directors will be at digesting or analyzing the information they do receive during their board tenure.

[112] Fairfax, *supra* note 58, at 164-67.
[113] Fisch, *supra* note 81, at 272.
[114] Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 356-57; Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 5 (noting that the board has "no easy way to generate "deep-dive" board meeting presentations into the firm's business and strategy that might inform a critical perspective on the management account").
[115] Kastiel & Nili, *supra* note 97, at 29.
[116] Fairfax, *supra* note 58, at 165.

The other problem that lack of knowledge and expertise exacerbates is board deference to management – the entire problem that independent boards were hailed as solving. Kastiel and Nili point out that lack of knowledge and expertise "increases the likelihood that independent directors may feel uncomfortable challenging managerial decisions that they do not understand and will further prompt deference to management and undermine directors' ability to be effective monitors."[117] Indeed, Jay Lorsch and Elizabeth MacIver argue that independent directors are more likely to be "pawns" rather than "potentates".[118] The likelihood of directors being "pawns" may be increased given that many independent directors have "substantial professional or personal ties to the corporation or its CEOs" despite their formally independent status.[119]

4. Board Passivity

Combined, the above factors usually result in a board that is fundamentally passive and reactive rather than proactive. It has been argued by Stevelman and Haan that "passive boards simply leave firms too vulnerable".[120] Gilson and Gordon also agree that an inevitable dynamic is that "the board typically will be reactive rather than pro-active; directors are information- and time-constrained and have bounded motivation in the intensity of their engagement".[121] If a company is targeted by activist shareholders who are proactive, the board is also often not in a good position to even react effectively or comment on the efficacy of the alternative proposals put forward by the activist. The board usually only reacts and plays a particularly active role in crisis situations. Therefore, the monitoring board is not forward looking. As noted by Fisch, "Even defenders of the monitoring board acknowledge that monitoring is properly characterized as a safety valve for crisis situations. A monitoring board facilitates dealing with problems; it does not solve ineffective operating strategies or assure good performance."[122]

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[117] Kastiel & Nili, *supra* note 97, at 29; Fairfax, *supra* note 58, at 164-65.
[118] Jay W. Lorsch with Elizabeth MacIver, Pawns or Potentates: The Reality of America's Corporate Boards (1989), cited in Gordon, *The Rise of Independent Directors*, *supra* note 57, at 1477.
[119] Fisch, *supra* note 81, at 270.
[120] Stevelman & Haan, *Information Governance*, *supra* note 15, at 238.
[121] Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 358; Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 6.
[122] Fisch, *supra* note 81, at 282, citing Benjamin E. Hermalin & Michael S. Weisbach, *The Effects of Board Composition and Direct Incentives on Firm Performance*, FIN. MGMT., 101, 111 (1991) ("observing that "the outside-director-as-monitor literature has focused on extraordinary event…from which it is difficult to ascertain the value of day-to-day monitoring by outside directors."").

5. Functions Beyond Monitoring

The fixation on agency costs and the monitoring role of independent directors has also led to other board functions being sidelined. In the late 1990s, Jill Fisch criticized the focus on independence as the sole criterion for evaluating boards and highlighted "the failure of many reformers fully to consider the appropriate scope of board function".[123] She forcefully argued that "[b]oard function need not be viewed solely in terms of monitoring management."[124] In particular, it was noted that boosting independent monitoring capability may prejudice the ability of the board to exercise its management function.[125] Prior to the relentless focus on agency costs and the emphasis on monitoring, the board of directors operated as the "ultimate managerial authority in the corporation".[126]

Indeed, corporations, their shareholders, and other stakeholders may benefit considerably from boards engaging in high level strategy discussions or analysis, or at least undertaking a process where the board evaluates management's proposed strategy.[127] Other problems associated with independent directors play a role here too, as the ability of independent directors to meaningfully fulfil such a function is constrained by the fact that such directors tend not to have the time, the firm-level expert knowledge, or the information and resources to meaningfully contribute to a critical analysis of corporate strategy. As noted by Fisch, "Independence is not the only relevant qualification for an effective managing board. In order to formulate a strategic plan, determine whether a merger will provide long-term value, or select an executive capable of running the business, directors need a detailed familiarity with and appreciation for the nature of the corporation they oversee."[128]

Ira Millstein laments the preoccupation of boards with "compliance" rather than corporate strategy, growth, and performance.[129] Increasing regulatory and compliance burdens on

[123] Fisch, *supra* note 81, at 267.
[124] Fisch, *supra* note 81, at 272.
[125] Fisch, *supra* note 81, at 267.
[126] Fisch, *supra* note 81, at 272.
[127] It is important to acknowledge that companies do have significant flexibility over the structure of their board. Therefore, observed board structure may reflect what is optimal for individual companies.
[128] Fisch, *supra* note 81, at 274.
[129] IRA. M. MILLSTEIN, THE ACTIVIST DIRECTOR, 186 (2017) (noting that "director attention has shifted priorities from managing the affairs of the corporation – corporate strategy, growth, and performance – to "compliance", a necessary but not sufficient responsibility for the activist director.")

the board are often partly blamed for independent directors lacking the time to become richly informed about the substantive activities of the corporation on whose board they sit.[130]

Taking all of these critiques into consideration, it is perhaps no surprise that empirical evidence on independent monitoring boards tends to be largely inconclusive regarding any association between independent boards and improved corporate performance (and also equally any association with reduced corporate performance).[131]

6. Twenty-First Century Challenges and Expectations

Gilson and Gordon argue that "the current 1970s conception of the monitoring board and its surrounding regulatory structure, however well-meaning and responsive to an earlier set of governance shortcomings, is no longer sufficient to meet twenty-first century governance challenges".[132] As the complexity of corporate activity and contemporary challenges grow, Kastiel and Nili have also argued that "'[a]s part-time employees who often sit on multiple boards, outside directors lack the time, adequate resources, and the industry-specific knowledge to properly obtain, digest, and analyze the extensive and complex information that modern boards are tasked with evaluating."[133] Ira Millstein, similarly claims that boards need to go beyond monitoring given increased challenges and expectations, noting that "Boards have the same mindset they did decades ago…Back then, boards could remain relatively passive and entrust their managers to grow the corporation. Today the mantra most common in corporate America is still this: "Boards don't manage, they just oversee". Far too many directors take that hands-off approach; they check the legal compliance boxes and otherwise limit their involvement. The future of the corporation – strategy – is left to management."[134]

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[130] Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 356-57; Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 5. However, *see* Armour, Garrett, Gordon & Min, *supra* note 89, at 1202 (presenting evidence that is "consistent with the theoretical claims that compliance is more often overlooked, rather than overseen, by boards.")

[131] Fairfax, *supra* note 58, at 176 (noting that "Taken as a whole, the empirical evidence does not convincingly prove that independent directors necessarily lead to more effective and efficient monitoring"); Gordon, *The Rise of Independent Directors*, *supra* note 57, at 1500 (noting that "Evidence that connects the increased presence of independent directors to shareholder benefit is weak at best.")

[132] Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 364.

[133] Kastiel & Nili, *supra* note 97, at 23.

[134] MILLSTEIN, *supra* note 129, at 180.

In light of the limitations of the monitoring board, Section III below considers whether the monitoring board can be re-imagined to better address complexities and challenges facing corporations.

III. RE-IMAGINING THE BOARD

The issues facing modern corporations and boards may be more complex than ever before. In the past, boards have largely focused on profit maximization and were not under so much pressure to grapple with a broader range of environmental and social issues. The investor base of public companies has also changed dramatically,[135] which can affect the dynamic between shareholders and the board. Gilson and Kraakman noted in the early 1990s that independent outside directors have been viewed as the "corporate equivalent of the Holy Grail" in the quest to solve agency problems and bridge the separation of ownership and control.[136] However, since the widespread adoption of the monitoring board, corporate scandals and the financial crisis have also led to increased regulatory burdens on American boards, for example through Sarbanes-Oxley in 2003 and Dodd-Frank in 2010. Increased shareholder and stakeholder pressure, especially on ESG issues, also continues to exert additional demands on boards, and expectations of risk management, stewardship, and engagement. In this context, and in light of the limitations of the dominant independent monitoring board model, it is timely to ask whether the board should be re-imagined to meet challenges facing corporations in the twenty-first century. As summarized by Gilson and Gordon, "The task that confronts today's public corporations is to respond effectively to the dramatic changes that have taken place since the emergence of the monitoring board and so better equip boards to function in a radically different business environment."[137]

A. A New Investor Ecosystem

One of the primary rationales underpinning the monitoring board was the rational apathy of dispersed shareholders. As detailed earlier, agency problems arise due to a separation of ownership and control, and dispersed retail investors had little incentive to be active or

[135] Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 10.
[136] Gilson & Kraakman, *supra* note 152, at 873.
[137] Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 3; Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 353.

intervene in corporate decision-making. Gilson and Gordon have noted that "boards that effectively monitored a company's managers on behalf of shareholders were viewed as the necessary complement to widely distributed ownership."[138]

However, three important developments have taken place since the 1970s that serve to highlight the deficiencies in the monitoring board. First, there has been a major shift from dispersed shareholdings to much more concentrated institutional ownership of public companies. Second, since the 2000s, there has been "the rise of a new form of financial intermediary, the activist hedge fund".[139] Third, there has been a significant shift to passive investing and an aggregation of power among the largest managers who offer such funds at the lowest cost.[140]

Combined, these developments have resulted in an increase in the prevalence of activist hedge fund campaigns at major companies in the United States. As a result, "even the largest public companies (and their management teams) are now subject to credible proxy contests by shareholder activists mounting challenges to management's strategic vision or operational competence."[141]

What does the rise in hedge fund activism and the growth of institutional investor ownership mean for the monitoring board? Boards certainly face more scrutiny from institutional investors. Some commentators have also highlighted the problem that "directors are poorly equipped and positioned to defend management against an activist's credible business counter-vision".[142] Therefore, the responsibility often falls to institutional investors to adjudicate on whether an activist campaign will be successful or not. This has resulted in institutional investors, especially global asset managers, being the pivotal voters in activist campaigns.[143] When critics of the monitoring board discuss activism, it is most often in the context of the board being in a poor position to defend against activist attacks.

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[138] Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 4; Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 354.
[139] Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 2; Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 353.
[140] *See infra* Chapter 5, Section I B.
[141] Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 2.
[142] Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 2-3; Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 353.
[143] *See infra* Chapter 5, Section I B.

What is missing from the literature is an account of what the campaign strategies of activist hedge funds can teach us about re-imagining the board to meet contemporary corporate challenges.

B. Reimagining the Board

Is a re-imagining of the board likely to materialize? Gilson and Gordon have explained that the deficiencies of the advising board model helped to shape the alternative of the monitoring board. However, the limitations of the monitoring board have been well known for some time. It was also explained earlier that one of the main catalysts in the transformation of the advisory board to the monitoring board was the impetus to use independent directors as a shield against hostile takeovers; "CEOs came to see the legal advantage of independent directors in helping to fend off unsolicited takeover bids"[144] The next iteration of the corporate board may require a similar catalyst. Could the next generation of corporate boards evolve in response to the campaigns of activist hedge funds? The rise of activist hedge fund nominated board directors – explored fully in Chapters 3 and 4 – may have a role to play in reforming the corporate board. If activist campaigns heighten expectations of board directors to go beyond monitoring, we may see corporate boards beginning to act defensively by putting in place more robust boards overseeing strategy and operations, in anticipation of being targeted by an activist hedge fund. Before considering this, the below sections outline some ways in which commentators have already envisaged reinventing the board.

From the outset, it is important to clarify that there are essentially two main ways to re-imagine the board. The first is what function the board performs, whether that be advising the CEO, overseeing strategy, or acting as a team of experts. What role do we expect boards to play in twenty-first century firms? The second is board composition. Independent directors have become the norm, but there are various drawbacks to a board composed almost exclusively of corporate outsiders. Relatedly, proposals have been made with respect to other shortcomings of the current board model, such as the problem of thinly informed and under-resourced directors. How might we ensure that board members

[144] Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 4; Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 356.

have sufficient resources to assess the information they need to effectively discharge their responsibilities? Another consideration which is relevant to the concept of activist board representation explored Chapters 3 and 4 is who should elect the board. Again, scholars have made various proposals over the years to reflect shareholder democracy and improve representation on the board.

1. Board Function

In the 1990s, Fisch advocated that "reformers and commentators need to take board function more seriously".[145] That ideal has not materialized, but it may increasingly come to the forefront of the corporate governance agenda as a result of greater expectations of boards and the upward trend of activist board representation campaigns (discussed in Chapter 4) which expose the shortcomings of the monitoring board.

Indeed, if activist hedge funds and their board nominees continue to challenge the strategic vision or operational competence of incumbent managers, then the board model may be forced to change. In his book, *The Activist Director*, Millstein advocates for a new breed of "activist director".[146] Not to be confused with hedge fund activist board representation, Millstein – an advocate of board-centric corporate governance – defines "activist directors" as "people who will ask the tough questions, challenge management practices, and resist those who put their own agendas ahead of those of the corporation and investors".[147] Chapters 3 and 4 consider the role of directors appointed by activist hedge funds who may play a similar function. But here it is relevant to add that Millstein envisages such directors taking a forward-looking rather than reactive, crisis driven role in terms of the success of the corporation. In particular, he notes that he imagines an activist board that will "spur passive directors to their responsibilities"[148] and that is "knowledgeable, thinks independently, and is interested enough to *partner* with management in designing the corporation's future, which management can then execute."[149] While this vision is appealing in theory, actually creating such an engaged and involved board in practice presents much more of a challenge. Nevertheless, activist

[145] Fisch, *supra* note 81, at 272.
[146] MILLSTEIN, *supra* note 129, at 181 & 184.
[147] MILLSTEIN, *supra* note 129, at ix.
[148] MILLSTEIN, *supra* note 129, at 181 and 184.
[149] MILLSTEIN, *supra* note 129, at 187.

campaigns are drawing attention to the limited scope of the monitoring role and the lack of board involvement in other functions.

2. Board Composition

As discussed in Section II above, independent directors are the norm in U.S. public companies. There were, however, advantages to having some insider directors such as those who sat on the advisory board. Fairfax argues that "[inside] directors can add value to the board because they are better informed and more knowledgeable than independent directors."[150] They also "invest considerable time and resources into the corporation, which translates into superior knowledge about the company."[151] Ultimately, what may be most important is the time that directors are willing to invest in their board service, as well as the depth of information and knowledge they have about the company's activities. Board composition should not be an end in itself. Rather its consideration should be a means of ensuring the ultimate goal which is good board governance. That can be a combination of monitoring and also critical and forward-looking analysis of corporate strategy and operations, as well as deep consideration of ESG issues. There is not necessarily a one size fits all director that can meet these ideals. There may be tradeoffs between a particular director's ability to monitor effectively that need to be balanced with a potentially stronger contribution to the board's management role.

3. Who Elects the Board?

Throughout corporate law scholarship, there have been continuing debates and proposals for investors – especially institutional investors – to become more involved in the director election process. In the early 1990s, Gilson and Kraakman proposed an agenda for institutional investors, envisaging that they could collectively nominate professional outside directors who would actively monitor public corporations in the shareholders' interest.[152] They advocated that "an ideal mechanism for delegating monitoring would seem to be the expert director, chosen cooperatively by institutional investors", while also acknowledging that "the system of outside directors itself is in need of reform".[153] At the

[150] Fairfax, *supra* note 58, at 179.
[151] Id.
[152] Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 883-884 (1991).
[153] Gilson & Kraakman, *supra* note 152, at 880.

time, the proposal was still squarely premised on the idea of the monitoring board, rather than envisaging a more substantive and strategic set of responsibilities for directors. Essentially, it was thought that introducing a new class of high-quality *professional* directors who were outsiders and independent of management would improve the incentives for directors to monitor effectively and their ability to do so. Since Gilson and Kraakman made this proposal, "institutional investors have continued to publicly favor higher quality board members. However, they also remain reluctant to get into the activity of selecting or actively influencing the choice of directors."[154]

More recently, John Coffee proposed that investors such as the Big Three asset managers "could form (with other similarly-minded institutions) a steering committee and assemble a team of outside directors (who were not their employees) that they could seek to place on corporate boards".[155] Coffee suggested that these asset managers could take such a course of action if they feared being disenfranchised by private settlements between activist hedge funds and target companies, and noted that the costs could be distributed among the multiple institutions participating in such a committee.[156]

Therefore, it is clear that there is some scholarly appetite for shareholders, especially large institutional investors, directly nominating or becoming more involved in director recruitment and nomination.

4. Information and Resources

One of the two major factors Gordon identified as a driver of the independent board was fundamental changes in the information environment which "reworked the ratio of the firm's reliance on private information to its reliance on information impounded in prevailing stock market prices."[157] However, as noted above,[158] overreliance on stock

[154] Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 365.
[155] John C. Coffee Jr., *The Agency Costs of Activism: Information Leakage, Thwarted Majorities, and the Public Morality*, 26 (Eur. Corp. Governance Inst., Law Working Paper No. 373/2017, 2017), https://ssrn.com/abstract_id=3058319 [hereinafter *The Agency Costs of Activism*].
[156] *Id.*, at 14.
[157] Gordon, *The Rise of Independent Directors*, *supra* note 57, at 1469-70 (noting also that "Special access to private information became less important.") The other factor was the evolution of corporate purpose from stakeholder concerns being a key part of 1950s managerialism to shareholder wealth maximization being the primary or sole focus in the 1990s and 2000s.
[158] *See supra* Chapter 1, Section I B.

prices is not a substitute for deep knowledge regarding the company's strategy and operations.

Other scholars have made separate proposals to overcome the issues associated with independent directors lacking information and resources. In 2018, Bainbridge and Henderson put forward an idea to "outsource the board" via "Board Service Providers".[159] They explain that "[i]nstead of such a board comprising individuals, we propose allowing corporations to hire another business entity to act as the board of directors".[160] Such corporations would provide director services and it is argued that the market for corporate governance would result in superior board services than those that currently exist. Bainbridge and Henderson "envision board service as a profession that qualified candidates could train for and build expertise in".[161]

Kastiel and Nili also advance an idea to overcome the informational challenges faced by board members. Their proposal is intended to overcome the informational deficiencies faced by the board through private ordering by creating a dedicated office, or "Board Suite", (with a special counsel and dedicated secretariat) that would be in charge of independent data collection and dissemination, so as to minimise the dependence of the board on management for its information.[162] Such a proposal could support directors by ensuring they have "timely, concise, unbiased information, potentially from many different areas of the firm."[163] This idea is reminiscent of Eisenberg's observation that effective monitoring requires the board to play a role in "establishing multiple, independent, backstopping channels of information reporting immediately to board directors rather than the C-suite."[164] Overall, Kastiel and Nili claim "that a board suite, consisting of an office of the board and an independent general counsel to the board, would close the board's information gap".[165]

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[159] *See generally* BAINBRIDGE & HENDERSON, *supra* note 65.
[160] BAINBRIDGE & HENDERSON, *supra* note 65, at 90.
[161] Stevelman & Haan, *Board Governance*, *supra* note 70, at 331.
[162] Kastiel & Nili, *supra* note 97, at 52.
[163] Stevelman & Haan, *Board Governance*, *supra* note 70, at 346.
[164] *Id.*, citing Melvin A. Eisenberg, *Corporate Governance: The Board of Directors and Internal Controls*, 19 CARDOZO L. REV. 237 (1997) (finding that directors must increasingly attend to the establishment of multiple robust systems of internal reporting and data gathering, consistent with their fiduciary responsibilities and securities laws mandates).
[165] Stevelman & Haan, *Information Governance*, *supra* note 182, at 268, citing Kastiel & Nili, *supra* note 97, at 52-55.

5. Proposals for a Re-imagined Board

Most recently, Gilson and Gordon have proposed "Board 3.0", "a board that contains a mix of directors from the current Board 2.0 [monitoring] model and "empowered" directors ("3.0 directors") who would be charged specifically with monitoring the strategy and operational performance of the management team."[166] Gilson and Gordon's Board 3.0 model therefore aims to address the overemphasis on monitoring as the sole board function and envisages a board model where directors are "*thickly informed, well-resourced,* and *highly motivated*"[167] so as to "effectively monitor managerial strategy and operational skill in cases where this would be particularly valuable."[168] Gilson and Gordon emphasize that despite the consistent focus on the monitoring board in public companies, "the world of private markets, venture capital and private equity – all post-1976 developments – have made effective use of alternative board models."[169] The model proposed takes its inspiration from the private equity industry, where the governance practices do not suffer from the same deficiencies as those afflicting the independent monitoring board.[170] The private equity-type model proposed also tackles the problem of information and resources, noting that the directors "would be supported by a "strategic analysis office" that would provide back-up support for a 3.0 director's engagement with the management team."[171] One significant drawback of the proposed alternative board model is the likely cost of implementing such a system. In particular, Gilson and Gordon stress that compensation for the new directors and staffing of the strategic analysis office could prove to be large costs.[172]

C. Beyond Monitoring: Activist Directors

As outlined earlier, one of the major criticisms of the monitoring board is the fact that independent directors may be unlikely to make substantive, forward looking contributions

[166] Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 8; Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 361.
[167] Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 7; Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 359.
[168] Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 3.
[169] Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 8; Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 361.
[170] Id.
[171] Id.
[172] Id.

to the company's strategy and operations. Chapters 3 and 4 of this thesis investigates the link between strategic and operational activism and activist board representation. If minority directors appointed by activist hedge funds are focusing on strategy and operations, with the support of the back office of the hedge fund to assess information, then this both exposes a problem of the monitoring board and presents a potential solution. Stevelman and Haan argue that we are already witnessing a shift away from the monitoring board[173] – something which may also be evident in the success of activist board representation campaigns. In their view, a serious deficiency of the monitoring board is that it "failed to empower boards to assume a robust role in vetting and advising on strategy".[174] As demonstrated in Chapters 3 and 4, that is a gap that hedge fund appointed directors have often been able to fill. However, rather than identifying hedge fund appointed activist directors as a helpful example of when informed and engaged directors can contribute to strategy and operations and thus value creation for the corporation, most commentators only discuss boards and activist campaigns in the context of the monitoring board being in a poor position to assess the merits of an activist campaign due to the limitations of such a board model that have already been discussed.

This thesis goes further and contributes to the literature by identifying that not only does hedge fund activism – and more specifically activist board representation – expose the limitations of the monitoring board model, it also provides a real-life example illustrating a potentially superior board model in action. Much like Gilson and Gordon's Board 3.0 proposal that emulates private equity board governance, activist directors nominated by a hedge fund similarly often become deeply involved in analysis of corporate strategy and operations and ways to create value through improvements to such strategies.

Activist appointed directors can indeed mitigate many of the shortcomings of the monitoring board. First, counteracting the problem of part-time directors, activist directors tend to invest much more time and energy in their role (especially when the director is affiliated with the activist hedge fund). Second, activist directors can both generate and seek additional information that helps to reduce the informational asymmetries that afflict independent directors on the monitoring board. Third, activist directors go beyond

[173] Stevelman & Haan, *Information Governance*, *supra* note 15, at 183.
[174] Stevelman & Haan, *Information Governance*, *supra* note 15, at 185.

monitoring and get involved in strategic analysis and a management function. Therefore, they encapsulate many of the advantages of insider directors on the old-style advisory board, but they have a separation from the company, its executives and importantly the CEO as they are appointed by an investor rather than being hand-picked by the CEO for their loyalty. The combination of these factors could considerably improve the effectiveness of the corporate boards on which activist directors sit. By perceiving activist hedge funds as a negative force, commentators largely overlook the lessons that could be gained from studying the positive features of activist board representation campaigns. For example, Stevelman and Haan consider the situation where "activists come armed with impressive-looking, sophisticated studies and reports" in order to "press for swift cash payouts or other fundamental changes."[175] They rightly identify how the monitoring board is ill-equipped to respond to such activist challenges. However, what is not discussed is that activist hedge funds can provide a solution to the problems of the monitoring board rather than simply being seen as a problem that the board needs to defend against. A study of activist board representation (as contained in Chapters 3 and 4) reveals that the main focus of activist campaigns where there is board representation is strategy and operations. The fact that activist hedge funds and their nominees may have better information than the incumbent board is not necessarily a problem and instead can illustrate the benefits of informed boards engaging in strategy, operations, and sustainable value creation.

The independent monitoring board and activist shareholders are usually presented as alternative solutions to agency problems.[176] But what if solutions for board reform can actually be gleaned from studying modern shareholder activism, in particular activist board representation?

1. Focus on Strategy and Operations

It has been noted that the "monitoring board" is most definitely not a "strategy board".[177] As previously discussed, it is difficult for independent directors to become involved in strategic analysis. Rather, the focus has always been on limiting shareholder-manager

[175] Stevelman & Haan, *Board Governance*, *supra* note 70, at 346.
[176] Pargendler, *supra* note 73, at 369 (noting ""two formulas of internal governance have received the lion's share of attention over time: the monitoring role of the board of directors and the active role of shareholders.")
[177] Stevelman & Haan, *Information Governance*, *supra* note 15, at 264.

agency costs, particularly stealing and shirking. By contrast, Chapters 3 and 4 illustrate that one of the main features associated with activist hedge fund minority board representation is the accompanying focus on strategy and operations. Unlike the financial engineering that hedge funds have commonly been criticized for engaging in, when activist hedge funds gain board seats, they are much more likely to focus their activism on turning around the strategy and operations of the target company. As noted by Gilson and Gordon, "activists come forward with criticisms of the company's strategy and/or management's operational skill" and often have "elaborate external critique and proposals for change."[178] Indeed, activist hedge funds invest considerable resources in acquiring deep firm-specific knowledge relating to their target companies. This can result in them being much better informed of the corporate strategy and operations than the incumbent board. If the activist hedge fund is successful in securing a board seat, that can also be a way to gain additional information by virtue of becoming an insider on the board. Activist directors will likely be much more proactive in terms of acquiring and evaluating the information that they can obtain through their board position. Therefore, they solve many of the problems discussed earlier and emulate many of the proposals that scholars have put forward for an alternative board model.

2. Sustainable Value Creation and ESG

It has been emphasized by Gilson and Gordon that "there are plainly observable reasons to think the present public company board model is hardly the "end of history" for corporate governance" and that "governance has to evolve to match the radical changes in the markets in which public companies operate".[179] Activist appointed directors can demonstrate the potential for a different board model where the board actually contributes proactively to sustainable value creation, rather than being more passive and reacting only if situations where a corporate crisis arises.

Chapter 6 discusses the contribution that activist board directors can make to the ESG agenda, especially if the nominees have specialized industry knowledge and expertise and capability in climate science or energy transition.

[178] Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 6.
[179] Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 354; Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 3.

D. Impediments to an Activist Board

Despite the benefits associated with activist board representation, anything involving activist hedge funds tends to be polarizing and often interpreted negatively. Chapter 2 sheds some light on why this is the case in the context of the short-termism narrative. Therefore, a transition to what we might call an activist board, or even an openness to learn from the positive features of activist board representation campaigns, is much less palatable than the shift from the monitoring board to the advisory board ultimately was. Pargendler has noted that "[t]he call for greater board independence gathered broad support, in part because of its political ambiguity. Social activists viewed independent directors as a suitable – if not ideal – mechanism to render corporate management more sensitive to the public interest. Other commentators, by contrast, regarded the rise of independent directors as perfectly consistent with the goal of maximizing shareholder wealth."[180] It was detailed earlier how the hostile takeover wave cemented the position of independent directors in corporate governance as they were suddenly a better option for managerial elites than the alternatives. As explained previously, "outside directors likely looked so palatable to business interests in view of the far more radical character of the alternative policy prescriptions floating around at that juncture".[181] By contrast, boards comprising activist hedge fund nominated directors are much less likely to engender universal support. Therefore, moves to emulate the activist board might only take place in the context of the activist defense industry – in order to protect themselves from activist attacks, companies might pre-emptively improve the quality of the board as well as broadening the board's function. Regardless of the motivation, this would likely be a positive development. In fact, many law firms and others involved in activist defense are already advising boards to boost their climate and ESG capabilities in order to avoid becoming an easy target for activist hedge funds to criticize their poor ESG practices. Companies would still need to find a way to emulate the activist hedge fund model in other respects, though. The activist hedge fund "back office" is a primary example as this provides activist directors with much needed information, resources and analytical

[180] Pargendler, *supra* note 73, at 376, citing Victor Brudney, *The Independent Director – Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597 (1982) ("Numerous observers have argued that the addition of independent directors to corporate boards would solve the problem of corporate social responsibility without incurring the costs of external regulation") and Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1259 (1982) ("Unlike the arguments for shareholder democracy, a plausible case can be made that boards dominated by independent directors will increase shareholders' welfare.")
[181] Pargendler, *supra* note 73, at 377.

support. In many respects it resembles the board suite put forward by Kastiel and Nili to attempt to overcome the informational deficiencies and under-resourced nature of the monitoring board.

IV. A NEW FOCUS ON EXTERNALITIES

A. An Omission from Agency Costs Theory

Stated very simply, agency theory does not consider corporate externalities. Instead, "agency theory pushed boards and CEOs to ignore all matters other than shareholder wealth" and also to focus on stock prices rather than other measures of corporate success.[182] As the core problem, articulated in 1976, was viewed to be the shareholder-manager agency problem, then any proposed solutions to that problem would necessarily also be assessed using the same framework. Independent directors were proposed on the basis that monitoring of corporate managers would mitigate agency costs, and the success of this and other corporate governance solutions have been routinely evaluated using the same agency cost framework. Hedge fund activism is viewed as another potential solution to the shareholder-manager agency problem. Therefore, the vast majority of scholarship assessing the effectiveness of hedge fund activism also uses an agency cost framework. The focus on agency costs theory has always been criticized to some extent. For example, Martin Lipton has argued that the "simplistic principal/agent theories" "cry out for re-examination", as do "neo-classical models on only select principal/agent relationships."[183] More importantly, while the framework is incredibly useful, it does completely ignore other important challenges that do not fit within traditional agency theory, such as any negative externalities that result from corporate behavior. Due to the narrow focus on preventing managerial malfeasance (in particular self-dealing and shirking) and the similarly narrow goal of promoting shareholder wealth maximization, environmental and social issues remain overlooked in agency theory.

[182] Stevelman & Haan, *Information Governance*, *supra* note 15, at 209 (noting also that it was viewed appropriate "to leave such matters to action by the state").
[183] Martin Lipton, *Important Questions about Activist Hedge Funds*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 9, 2013) https://corpgov.law.harvard.edu/2013/03/09/important-questions-about-activist-hedge-funds/ (noting that "In what can only be considered a form of extortion, activist hedge funds are preying on American corporations to create short-term increases in the market price of their stock at the expense of long-term value.")

In decades past, this was generally viewed as perfectly acceptable. Most companies "downplayed their impact on the environment",[184] and this was certainly common during the 1970s when agency theory was articulated. In any event, even on occasions where corporate externalities were highlighted, the prevalent view was that such matters were squarely within the remit of other fields of law, such as environmental law or tort law, as opposed to being a relevant consideration for corporate law and governance. This approach – where all matters other than shareholder wealth are left to the state and external regulation – has been helpfully labelled by Stevelman and Haan as "separate realms" thinking.[185] Nowadays, such a narrow focus is becoming less popular and less acceptable. Indeed, Stevelman and Haan argue that "[t]he 2020 pandemic, economic crises, investors' demands for socially responsible stewardship, and corporations' own political activism have rendered separate realms thinking untenable."[186]

The "separate realms" approach described by Stevelman and Haan reflects that taken by Milton Friedman in his celebrated 1970 *New York Times* essay, *The Social Responsibility of Business Is to Increase Its Profits*.[187] Here, Friedman argued for clear demarcation between the role of companies and the role of government – in the words of Oliver Hart and Luigi Zingales, "[p]ublic companies should focus on making money and leave ethical issues to individuals and governments".

This is not to say that corporate law theory has advocated for harm to society and the environment. Rather, as John Armour and Jeffrey Gordon note, it was thought that in an ideal world, "where a firm's activities do have adverse impacts on third parties, a range of legal mechanisms – contracts, liability rules and regulations act to ensure these costs are internalized into the firm's profit function."[188] If such mechanisms were effective, this would mean that negative externalities would be fully internalized by the corporation and thus by shareholders, who would "ultimately bear the social costs of any harmful

[184] Stevelman & Haan, *Information Governance*, *supra* note 15, at 209.
[185] *Id*.
[186] Stevelman & Haan, *Information Governance*, *supra* note 15, at 180.
[187] Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG. (Sept. 13, 1970), https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html.
[188] *See* John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35, 37 (2014) [hereinafter *Systemic Harms*] (noting that "where a firm's activities do have adverse impacts on third parties, a range of legal mechanisms – contracts, liability rules and regulation – act to ensure these costs are internalized into the firm's profit function.")

activities."[189] However, as the authors note, "[i]t's not news that these internalization mechanisms do not function properly".[190] Similarly, Hart and Zingales also argue that "Friedman is right only if the profit-making and damage-generating activities of companies are separable or if government perfectly internalizes externalities through laws and regulations. Neither of these seems very plausible."[191] Confidence in the ability of governments to address the most important issues facing society, such as climate change, has also likely declined since the 1970s.

As a result of separate realms thinking combined with imperfect internalization of externalities, a situation has been allowed to persist where corporations and their shareholders have been able to profit from harm done to other stakeholders. While concepts such as corporate social responsibility have been around for decades,[192] it is only much more recently that the environmental and social impacts of corporate behavior on other stakeholders have truly received widespread public attention and become a pressing mainstream concern. Dorothy Lund and Elizabeth Pollman note that "the evolution of corporate social responsibility into value-enhancing ESG has propelled it into the mainstream, as legal and market players no longer hinder but instead amplify these efforts."[193] Pargendler also suggests that "corporate governance has recently been enlisted as a solution to the great social issues of our time, such as income inequality, gender imbalance, human rights, and environmental protection."[194] As a result, "the outdated nature of the separate realms construct is dramatically apparent."[195] While it was once not really subject to scrutiny or concern, it seems less likely to persist given the global climate

[189] Armour & Gordon, *Systemic Harms*, *supra* note 188, at 37 (noting that "Where these internalization mechanisms function effectively, then shareholders ultimately bear the social costs of harmful activities.")
[190] Armour & Gordon, *Systemic Harms*, *supra* note 188, at 37. *See also* John Armour, *Shareholder Rights*, 36 OXFORD REV. OF ECON. POL'Y 314, 333 (2020) (noting that if markets and regulation functioned perfectly, the environmental implications of corporate action would be internalized on corporations and borne by shareholders but that since the financial crisis it has increasingly been challenged whether this is actually the case).
[191] Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J.L. FIN & ACCT 247, 270 (2017).
[192] Lund & Pollman, *supra* note 8, at 2612 (noting that "In the 1950s, economist Howard Bowen coined the term "corporate social responsibility" out of a concern for corporate power and its impact on society"), citing HOWARD R. BOWEN, SOCIAL RESPONSIBILITIES OF THE BUSINESSMAN 125-27 (1953).
[193] Lund & Pollman, *supra* note 8, at 2615.
[194] Pargendler, *supra* note 73, at 389 (noting also at 367 that "when the promise of corporate governance is extrapolated from mitigating agency costs (however economically significant they might be) to coping with externalities and distributional concerns as well – such as those arising from corruption, systemic risk, environmental harm, human rights, and gender inequity – the relentless emphasis on corporate governance becomes even clearer.")
[195] Stevelman & Haan, *Information Governance*, *supra* note 15, at 210.

crisis in particular. As Stevelman and Haan note, "this outlook better suited a simpler, older, more manufacturing-based economy, where unions attended to labor rights, and concerns about environmental damage remained marginalized. That economy and consciousness no longer predominates."[196]

What happens now that shareholders and stakeholders are increasingly accepting that corporations, their managers, and boards should play an important role in limiting negative externalities? Section B below considers the role of shareholders and the board in the ESG movement.

B. Shareholder and Board Focus on ESG

During the time that has passed since the agency costs framework was developed by economists, the corporate world has changed significantly, as has the investor landscape. Hart and Zingales have noted that corporations have become "larger, more complex and more powerful than they were in the 1970s and early 1980s when the traditional paradigm became established."[197] Similarly, Millstein has argued that "corporations face new realities in the vastly changed and changing capital market".[198]

1. Shareholder Pressure on ESG

Chapter 5 covers the transformation of the investor landscape in depth, including the passive index investing revolution and the surge in demand for ESG investment products. On a more basic level, share ownership is much more concentrated now than it was when agency theory was introduced and certainly when Berle and Means described the separation of ownership and control.[199] In particular, institutional investors are much more prominent than retail investors, and there has been a significant aggregation of power among large asset managers.[200] John Armour, Luca Enriques and Thom Wetzer have also

[196] Stevelman & Haan, *Information Governance*, *supra* note 15, at 209-10.
[197] Oliver Hart & Luigi Zingales, *The New Corporate Governance*, 1 U. CHI. BUS. L. REV. 195, 197 (2022) (noting that "Corporations are larger, more complex, and more powerful than they were in the 1970s and early 1980s when the traditional paradigm became established. In a more populous and interdependent world, the importance of externalities has also greatly increased, and many feel that governments are not dealing with them.")
[198] MILLSTEIN, *supra* note 129, at 201.
[199] Bebchuk, Cohen & Hirst, *supra* note 14, at 92.
[200] *See infra* Chapter 5, Section I B.

noted that "[a] growing body of evidence suggests that an expanding subset of investors place a higher valuation on firms that are making headway towards reducing emissions. We refer to these collectively as "climate-conscious investors."[201] Such climate-conscious investors are likely to want corporations, their managers, and their boards to minimize negative externalities. They are also likely to be willing to internalize externalities to some extent,[202] especially in the situation where the harms are systemic as "the firm's majoritarian diversified shareholders would prefer that the manages did not impose systemic externalities."[203] Investors are also increasingly demanding that boards pay serious attention to social, environmental, and political risks and challenges.[204] In particular, global asset managers are demanding that boards engage on ESG issues[205] and "[f]or boards, attending to the ESG risks investors care about has become an increasingly salient part of the job."[206]

2. Role of the Board in ESG

The board has already been completely reinvented once in recent history.[207] Gordon has also noted that "history makes us aware that many aspects of board function are jointly determined with the corporate purpose."[208] If the role of the board is to ensure that shareholder wealth is maximized, then that is a straightforward, clear, and singular goal. On the other hand, the increasing demands on boards to tackle ESG issues and address negative externalities makes the role of the board much more complex. These pressures may not result in sweeping reform to corporate purpose, but pressure from the public, shareholders and other stakeholders is likely to lead to – and in many respects has already led to – increased expectations on the board with respect to ESG. The board is therefore much more likely to be expected to play a key role in the corporation's ESG performance and risks.

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[201] John Armour, Luca Enriques & Thom Wetzer, *Green Pills*, (2023) ARIZ. L. REV. (forthcoming), http://ssrn.com/abstract_id=4190268.
[202] Hart & Zingales, *supra* note 197, at 248 (noting that "shareholders..also internalize externalities to some extent" and "if consumers and owners of private companies take social factors into account and internalize externalities in their own behavior, why would they not want the public companies they invest in to do the same?").
[203] Armour & Gordon, *Systemic Harms*, *supra* note 188, at 39.
[204] Stevelman & Haan, *Information Governance*, *supra* note 15, at 209.
[205] *See generally infra* Chapter 5; *see also* Stevelman & Haan, *supra* note 15, at 209.
[206] Stevelman & Haan, *Information Governance*, *supra* note 15, at 220.
[207] *See* Gordon, *The Rise of Independent Directors*, *supra* note 57, at 1510 (noting that after World War II, "heightened competitive pressure led to rapid changes in the board's role").
[208] Gordon, *The Rise of Independent Directors*, *supra* note 57, at 1510.

The heightened demands on boards are relevant to board composition as well as board function. Investor focus on the ESG capabilities of boards of directors is becoming more commonplace. Stevelman and Haan have noted that: "There is an upsurge in demands for boards better to understand and manage ESG risks, to supervise reliable ESG disclosures, and to take responsibility for fostering ethical firm cultures encompassing ESG concerns."[209] Pargendler has similarly observed that "properly structured boards of directors can play a crucial role in promoting the public good."[210] SEC Commissioner Allison Herren Lee recently noted in a speech that investors are increasingly emphasizing their expectations that boards need expertise on climate and ESG risks.[211] In particular, she cites Vanguard's comment letter to the SEC on climate change disclosures where the asset manager expressed its view that corporate disclosure should enable investors "to assess the climate competency of a company's board".[212] In describing ways to improve board ESG competency, she notes that "efforts could include integrating ESG considerations into their nominating processes in order to recruit directors that will bring ESG expertise to the board."[213] Overall, it is clear that the expectation for boards to be climate-competent is increasingly becoming the norm and there is also pressure for boards to actively engage in ESG issues. The traditional monitoring role played by independent directors is likely to be insufficient to meet these expectations.

[209] Stevelman & Haan, *Information Governance*, *supra* note 15, at 211.
[210] Pargendler, *supra* note 73, at 389.
[211] Commissioner Allison Herren Lee, Climate, ESG, and the Board of Directors: "You Cannot Direct the Wind, But You Can Adjust Your Sails" (2021), https://www.sec.gov/news/speech/lee-climate-esg-board-of-directors#_ftn54.
[212] *Id.* citing VANGUARD COMMENT LETTER TO SEC, PUBLIC INPUT WELCOMED ON CLIMATE DISCLOSURES, at 3 (2021), https://www.sec.gov/comments/climate-disclosure/cll12-8906800-244148.pdf.
[213] *Id*.

Chapter 2 – Activist Hedge Funds and Short-Termism

I. THE NARRATIVE OF SHORT-TERMISM

As noted in Chapter 1, those who have critiqued the monitoring board have not considered hedge-fund appointed activist directors to be a solution, nor thought of it as an example of a different form of board governance from which we can learn anything from. Rather, most discussions of hedge fund activism tend to be framed negatively – situating activism as a vulnerability to which the deficient monitoring board is exposed to and needs protection from, rather than providing any insight or real-life example of an ideal to aspire to.

For example, Stevelman and Haan note that "activist hedge funds represent a trenchant, destabilizing force in contemporary governance" and stress that "[i]f a board is under-informed about the firm's resources, competitive position and strategic plans, it may too easily capitulate to the activist's proposal".[214] While the authors do acknowledge that some activist proposals may in fact be positive, they frame this realization in terms of the additional risk of the board rejecting a positive proposal, noting that "an unprepared board may too readily succumb to status quo bias, rejecting the activist's proposal out of false confidence in the existing plans, or on account of groupthink".[215] Similarly, Gilson and Gordon advocate that their proposed Board 3.0 model would enable the board to "credibly defend management to institutional owners in the face of shareholder activist challenges or credibly insist that management take seriously activist proposals that the board thinks warrant due consideration."[216]

What has largely been overlooked in the literature to date is an analysis of whether directors appointed by activist hedge funds can actually contribute positively to sustainable value creation and indeed ESG goals. This omission of activist directors from the debate may in part be due to the prevalent narrative of short-termism, which often reduces any

[214] Stevelman & Haan, *Information Governance*, *supra* note 15, at 202 (citing literature discussing the likely deleterious effects of activist campaigns and noting that "in their attempts to alter corporate financial or operating affairs in order to capture a greater, immediate surplus, activist hedge funds represent a trenchant, destabilizing force in contemporary governance.")
[215] Stevelman & Haan, *Information Governance*, *supra* note 15, at 207.
[216] Gilson & Gordon, *Board 3.0: Private-Equity Governance*, *supra* note 100, at 3.

meaningful discussion on hedge fund activism in the press, in politics, and sometimes even in academic literature, to generalized statements about the short-term nature of such funds and their activism. Mark Roe and Roy Shapira outline that the "narrative is simple: stock traders and shareholder activists, looking for a quick profit, systematically induce large public corporations to manage for the short-run."[217] Not only is the narrative simple; it is also powerful. Again, Roe and Shapira note that "[a]mong policymakers, the media, and executives, the consensus is that the short-termism problem is widespread and pernicious – and getting worse."[218]

This widespread belief in the detrimental effects of short-term hedge fund activism can impair a genuine and thorough analysis of the positive impact that activism may have, and stifle discussion on what might be learned from recent phenomena such as hedge fund appointed activist directors. Moreover, while it is acknowledged that there may undoubtedly be cases of "bad activism,"[219] this should not preclude serious discussion on the positive attributes of other activist campaigns or an analysis of whether some forms of hedge fund activism may be more socially beneficial than others.

A. The Power of the Short-Termism Narrative

The problem of stock market short-termism has been generally accepted in politics, in the media, and by the public. Mark Roe notes that the "fear that stock-market-driven short-termism is seriously harming the US economy is pervasive"[220] and that "[s]tock-market-driven short-termism is the rare corporate structural issue that both resonates with the public and has a place in political rhetoric."[221] Roe had noted in the 1990s that "the rhetoric of anti-short-termism, like the rhetoric of patriotism, is simple and widely supported" and this seems to be even more true today.[222] Similarly, the imagery of the role that activist hedge funds play as destructive short-term actors is equally powerful and prevalent. Routinely attacked for their perceived short-term focus, activist hedge funds

[217] Mark J. Roe & Roy Shapira, *The Power of the Narrative in Corporate Lawmaking*, 11 HARV. BUS. L. REV. 233, 234, 271-272 (2021).
[218] Roe & Shapira, *supra* note 217, at 234.
[219] The phrase "bad activist" is used in recent commentaries on hedge fund activism. *See* Jennifer G. Hill, *Good Activist/Bad Activist: The Rise of International Stewardship Codes* 41 SEATTLE U. L. REV. 497, 498 (2018).
[220] ROE, *supra* note 2, at 2.
[221] ROE, *supra* note 2, at 3.
[222] MARK J. ROE, STRONG MANAGERS, WEAK OWNERS 243 (1996).

have been termed "hit-and-run activists"[223] by Hillary Clinton. A German politician also described activist hedge funds as "swarms of locusts that fall on companies, stripping them bare before moving on".[224] Other vocal critics such as Martin Lipton have described activist hedge funds as "preying" on corporations[225] and exacerbating short-termism, which he describes as a "disease that infects American business".[226] Indeed, as Gilson and Gordon point out, "[a]ctivism battles are often cast as the struggle by management to pursue long-term strategies in the face of pressure to maximize in the short-term.[227] The phrases most often used portray activists as aggressors and their interventions as adversarial. For example, commentators talk about activist "attacks" and boards of directors are encouraged by their advisers to "forestall an attack" and be ready to "defend vigorously".[228] Moreover, there is vivid imagery of "Wall Street "wolf packs" hunting down companies to close and jobs to eliminate."[229] Roe and Shapira explore the role of narrative power, noting that the combination of short-termism's "negatives [being] easily stated, easily understood and regularly repeated" boosts its narrative power and popularity.[230]

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[223] Brandon Kochkodin & Caleb Melby, *Hillary Clinton Faults "Hit-and-Run" Activist Investors*, BLOOMBERG (July 24, 2015), https://www.bloomberg.com/news/articles/2015-07-24/hillary-clinton-faults-activist-investors-hit-and-run-tactics.

[224] *Locust Pocus*, THE ECONOMIST (May 5, 2005) https://www.economist.com/node/3935994 (quoting the comments of Franz Müntefering, former Chairman of the Social Democratic Party in Germany, who also argued that the associated profit-maximizing strategies of activist funds were a long-term threat to democracy).

[225] Lipton, *supra* note 183 (noting that "In what can only be considered a form of extortion, activist hedge funds are preying on American corporations to create short-term increases in the market price of their stock at the expense of long-term value").

[226] Martin Lipton, Jay W. Lorsch & Theodore N. Mirvis, *The Proposed "Shareholder Bill of Rights Act of 2009"*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 12, 2009) https://corpgov.law.harvard.edu/2009/05/12/the-proposed-shareholder-bill-of-rights-act-of-2009/ (arguing that "Short-termism is a disease that infects American business and distorts management and boardroom judgment. But it does not originate in the boardroom. It is bred in the trading rooms of hedge funds.")

[227] Gilson & Gordon, *Board 3.0: An Introduction*, *supra* note 68, at 358.

[228] Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1154 (2015) citing Martin Lipton & Sabastian V. Niles, *Dealing with Activist Hedge Funds*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 21, 2013) https://blogs.law.harvard.edu/corpgov/2013/11/21/dealing-with-activist-hedge-funds-2/ and Simpson Thacher & Bartlett LLP, *Shareholder activism in M&A Transactions*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 26, 2014) https://blogs.law.harvard.edu/corpgov/2014/02/26/sharheolder-activism-in-ma-transactions/.

[229] ROE, *supra* note 220, at 5.

[230] Roe & Shapira, *supra* note 217, at 235.

B. The War of the Narratives

Studying actual activist hedge fund campaigns can reveal a competing narrative, similar to what Roe and Shapira describe as the "*anti*-managerial narrative" that was popular during the 1980s deal decade.[231] Roe and Shapira describe this as "lazy executives protecting fiefdoms with "poison pills" and "greenmail" (a cousin, presumably, of blackmail) to unjustly enrich themselves (sometimes with "golden parachutes") and run down corporate America at workers' and the economy's expense."[232] Attempts to promote a similar anti-managerial narrative – which is reflective of the agency problems of stealing and shirking – can be seen from the statements made by some hedge fund activists in their campaigns over the years. For example, Daniel Loeb of the activist hedge fund Third Point is well known for his "poison-pen letters" to corporate executives. In 2005, he addressed the CEO of Star Gas Partners, stating "It is time for you to step down from your role as CEO and director so that you can do what you do best: retreat to your waterfront mansion in the Hamptons where you can play tennis and hobnob with your fellow socialites."[233] He also highlighted corporate perks in another letter to the CEO of Intercept in 2004, criticizing the CEO for "tooling around in a luxurious business jeet, possibly sipping Cristal champagne cocktails at shareholder expense."[234] More recently, during his campaign at Sotheby's in 2013, Loeb noted that "Sotheby's senior management feasted on organic delicacies and imbibed vintage wines at a cost to shareholders of multiple hundreds of thousands of dollars."[235] Other activist hedge fund managers have used similar tactics and language. David Einhorn of Greenlight Capital entitled his investor presentation at The St Joe Company in 2010 "Field of Schemes", while accusing the company of not accurately accounting for the value of its assets.[236] Carl Icahn has similarly critiqued CEOs and boards as seen in his campaign at Motorola in 2007 where he argued

[231] Roe & Shapira, *supra* note 217, at 274.
[232] Id.
[233] Lina Saigol, *…Yours truly, Dan Loeb*, FIN. TIMES (Oct. 3, 2013), https://www.ft.com/content/908e63c4-2c20-11e3-8b20-00144feab7de.
[234] Saigol, *supra* note 233.
[235] Samantha Sharf, *Poison Pens: 7 Of The Best Barbs From Activist Investors*, FORBES (Sep. 29, 2014), https://www.forbes.com/sites/samanthasharf/2014/09/29/poison-pens-7-of-the-best-barbs-from-activist-investors/?sh=273c48647cf9.
[236] Sharf, *supra* note 235.

"It is essential to the future of Motorola that its directors realize that the board, especially at this precarious time, is not a country club or a fraternity." [237]

Despite the vivid language used by activist hedge funds to conjure images of managerial stealing or shirking, it does not seem that activist hedge funds won the war of the narratives. Roe and Shapira have noted that a narrative of "executives at public companies entrenching themselves for power, prestige, and pay at the expense of shareholders, employees, and society overall" is "perhaps equally compelling".[238] Yet the short-termism narrative is much more widespread and popular. When similar anti-managerial narratives were used during the deal decade, corporate lawmaking nevertheless "shifted first to disciplining underperforming executives and then to blocking their opponents, the greedy raiders."[239] Since then, the short-termism rhetoric has prevailed, despite raiders reinventing themselves into more palatable activist shareholders.[240] Beyond that, the narrative of short-termism has strengthened in power over the decades that followed.[241] As explained below, this narrative has potentially gained even more power due to the fact that short-termism has been viewed as a cause of the global financial crisis, and as a contributing factor to the global climate crisis.

C. Increasing Narrative Power: ESG

The short-termism problem already increased in visibility during and after the global financial crisis. Some commentators have argued that it was pressure from activist shareholders that was "directly responsible for the short-termist fixation that led to the [2008-2009] financial crises".[242] The most important issues facing society, such as the climate crisis and other environmental damage, are also increasingly presented as a

[237] Matteo Tonello, *The Activism of Carl Icahn and Bill Ackman*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 29, 2014) https://corpgov.law.harvard.edu/2014/05/29/the-activism-of-carl-icahn-and-bill-ackman/.
[238] Roe & Shapira, *supra* note 217, at 275.
[239] Roe & Shapira, *supra* note 217, at 274.
[240] However, *see generally* Zohar Goshen & Reilly S. Steel, *Barbarians Inside the Gates: Raiders, Activists, and the Risk of Mistargeting* 132 YALE L. J. 411 (2022) (arguing that the conventional wisdom about corporate raiders and activist hedge funds – raiders break things and activists fix them – is wrong).
[241] Roe & Shapira, *supra* note 217, at 275 (noting that "that narrative faded because the media no longer bought in, or because wealthy and aggressive raiders and hedge fund activists could not credibly promote a narrative of their fighting greedy executives for the benefit of the America people, or because the idea was felled by narrative entrepreneurs who promoted a more powerful narrative, namely that stock-market driven short-termism was causing American economic decay.")
[242] Bebchuk, Brav & Jiang, *supra* note 228, at 1095, citing Lipton, Lorsch & Mirvis, *supra* note 226.

problem of short-termism. In short, it is argued that governments and corporations have put economic growth or short-term profits ahead of the long-term preservation of the planet. For example, at the World Economic Forum in Davos in 2023, the climate activist Greta Thunberg accused the political and business elite of "prioritizing self-greed, corporate greed and short-term economic profits above people and above planet".[243] Statements like this have resulted in the short-termism narrative gaining even more traction and power in recent years, as it is fueled by rightful anger regarding environmental and social harm. Roe explains that "[b]roader social and economic reasons help to explain why stock market short-termism is seen as seriously pernicious."[244] The narrative has essentially become part of the growing ESG movement, as it is "intertwined in public rhetoric with conceptualizations of corporate social responsibility, corporate purpose, and the need to emphasize corporate attention to the environment, stakeholders, and the risk of climate catastrophe, the so-called ESG issues."[245]

However, Roe and Shapira criticize the conflation of environmental and social problems and short-termism, arguing that "[e]nvironmental degradation, for example, is often portrayed as due to stock market short-termism, when it primarily emanates from the corporation's ability to offload costs externally to third parties, *not* from investors' time horizons."[246] Environmental damage is correctly stated as a "problem of *externalities*, not of short-termism".[247] Roe argues that a misstatement of the problem can confuse a discussion of the appropriate solution.[248] In the context of environmental damage, Roe and Shapira insist "[t]he proper remedy is *not* to alter the firm's time horizons, but to alter their (and our individual) incentives to internalize the externalities, via, say, a carbon tax."[249] Similarly, with hedge fund activism, an assumption that all (or most) hedge fund activism campaigns are short-termist in nature can lead to an unwillingness to consider campaigns on their merits, or a push for policies and regulations that curb all hedge fund

[243] Sam Meredith, Greta Thunberg says Davos elite are prioritizing greed and short-term profits over people and the planet, CNBC (Jan. 19, 2023), https://www-cnbc-com.cdn.ampproject.org/c/s/www.cnbc.com/amp/2023/01/19/greta-thunberg-says-davos-prioritizing-short-term-profits-over-planet.html.
[244] ROE, *supra* note 2, at 10.
[245] ROE, *supra* note 2, at 5.
[246] Roe & Shapira, *supra* note 217, at 236; *see also* ROE, *supra* note 220, at 5-6 (noting that "these corporate responsibility considerations are for the most part not time horizon issues").
[247] Roe & Shapira, *supra* note 217, at 234.
[248] ROE, *supra* note 2, at 7.
[249] Roe & Shapira, *supra* note 217, at 249.

activism. It would be preferable to have clear conclusions on whether hedge fund activism is short-termist, what types of activist strategies are short-termist, and whether any such short-termism is actually in conflict with long-term value creation. Unfortunately, when activists make proposals at target companies, they are often immediately lambasted for being rooted in short-termism rather than critics being open to the possibility that there might be a "legitimate disagreement on corporate strategy".[250]

D. The Effect of a Strong Narrative

Lucian Bebchuk, Alon Brav and Wei Jiang note that the "myopic-activists" claim has played a "central role in debates over shareholder activism and the legal rules and policies shaping it".[251] In particular, "[i]nvoking the long-term costs of activism has become a standard move in arguments for limiting the role, rights, and involvement of activist shareholders."[252] This strong narrative is consistently used and repeated in the political rhetoric focused on activist hedge funds. It is so powerful that it has even engendered bipartisan political support. One example of this is the Brokaw Act, which was co-sponsored by Senators Elizabeth Warren and Bernie Sanders in 2016. This was the first attempt at federal legislation aimed at regulating and restricting the "financial abuses being carried out by activist hedge funds who promote short-term gains at the expense of long-term growth".[253] Although the legislation ultimately failed, when it was re-introduced in 2017, it was as a bipartisan reform proposed by both Democrat and Republican senators.[254] Overall, therefore, short-termism is a powerful and common critique of hedge fund activism.

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[250] Roe & Shapira, *supra* note 217, at 257.
[251] Bebchuk, Brav & Jiang, *supra* note 228, at 1087.
[252] Bebchuk, Brav & Jiang, *supra* note 228, at 1088.
[253] Portia Crowe, *Bernie Sanders and Elizabeth Warren are going after activist hedge funds*, BUS. INSIDER (Mar. 18, 2016), https://businessinsider.com/elizabeth-warren-sponsors-activist-hedge-fund-bill-2016-3?r=US&IR=T.
[254] The Brokaw Act was originally proposed in March 2016 by United States Senators Tammy Baldwin and Jeff Merkley, was re-introduced in August 2017 as a bipartisan reform with Republican senator David Perdue, but ultimately failed. *See also generally* Alon Brav, J.B. Heaton & Jonathan Zandberg, *Failed Anti-Activist Legislation: The Curious Case of the Brokaw Act*, 11 J. BUS. ENTREPRENEURSHIP & L. 329 (2018).

II. BEYOND THE NARRATIVE: ACTIVIST HEDGE FUNDS AND SHORT-TERMISM

Due to the narrative's strength and key role in corporate lawmaking, it is important to delve more deeply into its actual implications for corporate governance. Looking beyond the simple narrative that is repeated in the media and in politics, there have been more serious critiques of activist hedge funds and short-termism in the academic literature. It has been argued that the "sharpest and most comprehensive criticism of hedge fund activism is that it exacerbates an already serious problem of "short-termism" in the executive suite".[255] In the academic literature, short-termism is not portrayed as simplistically as the political and media rhetoric suggests it is. Rather, short-termism inevitably comes into play when discussing hedge fund activism as it is "the potentially most important, most controversial, most ambiguous and most complex problem associated with hedge fund activism."[256]

In summary, the short-termism (or myopic-activists) argument essentially proceeds on the basis that the short-term investment horizons of activist hedge funds will induce target company directors and managers to pursue short-term profits and appreciation of the company's share price at the expense of the long-term success of the company. Whether this is actually the case in practice is vigorously debated by scholars. Nevertheless, short-termism is viewed as absolutely critical to debates on whether activist hedge funds are heroes or villains. Indeed, Marcel Kahan and Edward Rock have noted that "[o]ne's views about whether hedge fund activism, on the whole, is desirable or undesirable are likely to turn on one's stand on the short-termism problem".[257]

A. The Business Model of Activist Hedge Funds

Coffee and Palia have highlighted that "[t]he archetypal "transient investor" is probably the hedge fund."[258] Leo Strine has also similarly noted that "[m]any activist investors hold their stock for a very short period of time and may have the potential to reap profits based

[255] Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1083 (2007).
[256] Kahan & Rock, *supra* note 255, at 1087.
[257] Kahan & Rock, *supra* note 255, at 1083.
[258] Coffee & Palia, *supra* note 56, at 573.

on short-term trading strategies that arbitrage corporate policies."[259] Indeed, there are logical reasons why activist hedge funds may be more short-term oriented in their outlook compared to some other types of investors. The first is their business model and in particular the compensation structure that is typical for hedge fund managers. Activist hedge fund managers are usually remunerated using a formula whereby they charge 2% of the assets under management combined with a performance fee of 20% of the gains made by the portfolio. Therefore, the price at which activist hedge funds buy and sell stocks is crucial. In order to generate a strong performance fee for the manager, the fund ideally needs to secure quick returns that outperform the market. Their business model and compensation structure rely upon them maximizing returns on multiple investments then exiting to invest in new targets. This creates a strong incentive for an activist hedge fund manager to increase the value of the portfolio as quickly as possible. If they are not able to do this, their ultimate investors might withdraw their funds and switch to another fund with superior financial performance.[260] Some argue that this may lead to activist hedge funds "sacrificing the future for a quick buck."[261] Iman Anabtawi endorses this view, arguing that "the hedge fund is likely to favor policies by the firms in which it invests that produce short-term gains, even if a more patient investment orientation would generate higher returns over the long term."[262]

Concerns also relate to the fact that the short-term focus of hedge funds might also induce directors and managers themselves to engage in short-termist behavior due to fear of activist intervention (a concern that Bebchuk, Brav and Jiang have labelled the "counterproductive accountability" claim).[263] In the same vein, Leo Strine has argued that as directors are "increasingly vulnerable to pressure from activist investors", this may lead them to "sacrifice long-term performance for short-term shareholder wealth."[264] This concern may be exacerbated by the fact that directors and managers themselves may

[259] Leo E. Strine Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. L. 1, 8 (2010) [hereinafter *One Fundamental Corporate Governance Question*].
[260] Coffee & Palia, *supra* note 56, at 572-73.
[261] *See* Bebchuk, Brav & Jiang, *supra* note 228, at 1136, citing Lipton, *supra* note 183.
[262] Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 564 (2006).
[263] Bebchuk, Brav & Jiang, *supra* note 228, at 1087 and 1095; *see also* Lucian A. Bebchuk, *The Myth that Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1676-78 (2013).
[264] Leo E. Strine Jr., *The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law*, 50 WAKE FOREST L. REV. 761, 790-91 (2015) cited in ROE, *supra* note 2, at 19.

similarly have short-term interests at heart. The compensation of boards of directors and the incentives of CEOs and other managers historically revolve around short-term targets. It has been argued that a typical CEO would weigh results during their own expected tenure above longer-term results.[265]

B. Short-Termist Campaign Tactics

In addition to highlighting the general incentives that fund managers undoubtedly have to generate high returns as quickly as possible, critics of hedge fund activism most often draw attention to the type of campaign strategies that activists may prefer that can be viewed as short-termist. As a general criticism, there is the accusation that activist hedge funds effectively engage in "pump and dump" schemes. The tenor of this criticism is that all that activist hedge funds do is to "create a short-term spike in the target's stock price, then exit, leaving the other shareholders to experience diminished profitability over the long-run".[266] The implication is that there will ultimately be longer-term value destruction, with hedge funds only achieving a "short-term bump in the stock price" in order to "book quick profits" and then "bail out, leaving corporate management to clean up the mess."[267] Although the stock price of a company should theoretically be an accurate representation of the present value of expected future cash flows, the market may be much better at valuing short-term projects and visible quarterly earnings rather than complex long-term technologically sophisticated projects[268] or indeed the impact of climate risk.[269] Therefore, there can be a valuation bias in favor of the types of "quick fix" actions that hedge funds are known for implementing. Leo Strine also argues that activist hedge funds "can easily depart and not "eat their own cooking".[270]

More specifically, certain types of changes that hedge fund activists might promote may diminish the value of the corporation in the long run. The first general category is what can be described as "balance sheet activism", where activist hedge funds "sway and bully

[265] Mark J. Roe, *Corporate Short-Termism in the Boardroom and in the Courtroom*, 68 BUS. L. 977, 980 (2013) (noting that the average tenure for a CEO in the U.S. is seven years).
[266] Coffee & Palia, *supra* note 56, at 549.
[267] Bill George, *Activists Seek Short-Term Gain, Not Long-Term Value*, N.Y. TIMES (Aug. 26, 2013), http://dealbook.nytimes.com/2013/08/26/activists-seek-short-term-gain-not-long-term-value/.
[268] ROE, *supra* note 2, at 78.
[269] *See generally* Madison Condon, *Market Myopia's Climate Bubble*, 1 UTAH L. REV. 63 (2022).
[270] Strine, *One Fundamental Corporate Governance Question*, *supra* note 259, at 8.

management to…meet the quarterly targets and disgorge cash in extra dividends or stock buy backs in lieu of investing in long-term growth."[271] Bebchuk, Brav and Jiang categorize these types of interventions as "investment-limiting interventions" and include within the category (i) increased leverage; (ii) increased shareholder payouts (whether through dividends or stock buybacks); and (iii) reduced long-term investment in research and development."[272] These forms of hedge fund activism were viewed to be pervasive in the 2000s and 2010s, and indeed form a core part of the activist playbook. Strine has pointed out that "[i]t is easy to find examples of activism designed to encourage boards to increase leverage in order to pump up immediate returns to stockholders".[273] Later in the thesis, I label these common criticisms of activist hedge funds engaging in financial engineering and returns of cash to shareholders as *Activism 1.0* and discuss whether this represents the state of modern day hedge fund activism.[274] Nevertheless, the prevailing narrative regarding activist hedge funds tends to persist the present day, in that they are viewed as "primarily financial engineers interested in the largest possible profit in the shortest period of time."[275]

C. Empirical Evidence on Short-Termism

What are the normal investment periods of hedge fund activists in their target companies? In 2007, it was noted that the median holding period for activist hedge fund investments was around 20 months.[276] Empirical studies have generally shown that hedge fund activist campaigns typically result in short-term gains for shareholders. In terms of value creation

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[271] 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/.

[272] Coffee & Palia, *supra* note 56, at 549, 553, 573-77 (noting that activist hedge fund interventions often involve increases in leverage and shareholder payouts and decreases in investment, particularly long-term investment in research and development); Bebchuk, Brav & Jiang, *supra* note 228, at 1136-38; William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L. J. 1375, 1379 (2007) (noting that hedge funds typically seek sale of the company, or a division, or a large cash payment from a special dividend or stock repurchase). On research and development, *see generally* Alon Brav, Wei Jiang, Song Ma and Xuan Tian, *How Does Hedge Fund Activism Reshape Corporate Innovation?*, 130 J. FIN. ECON. 237 (2018) (presenting empirical evidence that firms targeted by hedge fund activists actually experience an improvement in innovation efficiency despite a tightening in R&D expenditures).

[273] Strine, *One Fundamental Corporate Governance Question*, *supra* note 259, at 13, citing *Shareholder Activism: Boon, Bane or Both?*, N.Y. TIMES DEALBOOK (June 13, 2007) http://dealbook.blogs.nytimes.com/2007/06/13/shareholder-activism-boon-bane-or-both/?scp=4&sq=investor%20activism%201everage6a:st=Search.

[274] *See infra* Chapters 3, 4 and 6.

[275] Iman Anabtawi, *supra* note 262, at 580.

[276] Bebchuk, Brav & Jiang, *supra* note 228, at 1087.

around the announcement of activism itself, studies in the 2000s on hedge fund activism in the United States have documented that the filing of a Schedule 13D by an activist hedge fund results in positive share price spikes.[277] More recent data confirming this effect is available in Bebchuk, Brav and Jiang's study in 2015, where it was discovered that the average abnormal returns for the twenty day period before and after an activist investor files a Schedule 13D are approximately six percent.[278] Therefore, the empirical evidence in relation to abnormal short-term gains from activist intervention is quite clear. This has led some proponents of hedge fund activism to argue that "this positive market reaction to the appearance of a hedge fund activist is consistent with the view that activists provide benefits to, rather than impose costs on, the targets of their campaigns".[279]

With respect to the long-term effects of hedge fund activism, however, the empirical evidence tends to be more mixed. Some opponents of hedge fund activism argue that the short-term stock price spikes that arise upon an activist intervention are reversed over time, as market myopia fails to account for the likely negative long-term stock returns.[280] Some

[277] Coffee & Palia, *supra* note 56, at 551. *See* Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1755-57 (2008) [hereinafter *Hedge Fund Activism*] (documenting an average 7.2% abnormal buy-and-hold return in 20 days post-Schedule 13D filing for the overall sample and an average (median) abnormal return of 8.4% for campaigns in which a hedge fund describes a new and explicit agenda in the Schedule 13D beyond a general statement of maximizing shareholder value in the filing); April Klein & Emmanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors* 64 J. FIN. 187, 207-11, 225-26 (2009) [noting a mean (median) size-adjusted return of 7.3% (4.9%) and 10.2% (8.9%) during event windows 5 days and 30 days post-filing, respectively); Christopher P. Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists*, 14 J. CORP. FIN. 323, 328-29 (2008) [noting that firms targeted by activists earn a mean size-adjusted return of 3.39% around the 13D filing date, using an event window of 2 days pre- and post-filing); Robin Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON. 362, 362-75 (2009) (noting that the immediate returns to activism are approximately 3.5% over a 15-day event window). *See also* Bebchuk, Brav & Jiang, *supra* note 228, at 1121 for a summary of the empirical evidence documenting the initial positive (short-term) stock market reaction to activist hedge fund interventions. *See generally also* Marco Becht, Julian R. Franks, Jeremy Grant & Hannes F. Wagner, *Returns to Hedge Fund Activism: An International Study*, 30 REV. FIN. STUD. 2933 (2017) (noting that disclosures of activist interventions are accompanied by positive abnormal stock returns in more than twenty stock markets outside the United States).

[278] Bebchuk, Brav & Jiang, *supra* note 228, at 1122 (noting that the average abnormal return in a forty-day window surrounding the filing of a Schedule 13D in their sample of activist interventions from 1994 to 2007 are approximately 6%).

[279] Bebchuk, Brav & Jiang, *supra* note 228, at 1122.

[280] *See* Bebchuk, Brav & Jiang, *supra* note 228, at 1120-21 (noting that "opponents of hedge fund activism believe that the initially positive stock-market reaction to activist interventions represent inefficient, myopic market pricing that fails to reflect the subsequent negative returns that are experienced by long-term shareholders and make such shareholders worse off."). *See also* Kahan & Rock, *supra* note 255, at 1084 (noting that "for the short-term trading horizon of hedge funds to generate a short-term investment outlook for hedge fund managers, the stock market must suffer from myopia: that is, it must undervalue long-term investments relative to short-term investments. If the market does not itself suffer from such a bias, then the interests of investors with short-term trading horizons will not conflict with those of investors with long-term trading horizons.")

studies indeed suggest that there is no statistically significant change in the long-term operating performance of targeted companies.[281] On the other hand, Bebchuk, Brav and Jiang have analyzed the long-term effects of hedge fund activism (which they define as a 5-year period following activist intervention) and contend that "[o]verall the analysis of stock returns carried out provides no support for the claim that activist intervention makes shareholders of target companies worse off in the long term."[282] There is no real consensus on this point, and scholars continue to debate whether the short-term gains from activist intervention are reversed in the long run. It can also prove difficult to empirically test whether hedge fund activism is beneficial in the long run, as there are so many intervening variables in corporate performance following an activist intervention.

D. Conflicts between Shareholders

If hedge fund activism causes corporations to be worse off in the long run, the same must of course be said for long-term shareholders such as pension funds or index funds. This would necessarily create a conflict between the interests of short-term activist hedge fund investors ("shareholders who plan to sell their shares within days or months") and longer-term investors ("who hold their securities for years or decades").[283] In fact, many commentators do consider the interests of short-term shareholders and long-term shareholders to be obviously in conflict. For example, Anabtawi argues that "[h]eterogeneity among shareholders with respect to their expected holding periods can lead to differences in shareholder preferences over corporate decisionmaking," with long-term shareholders preferring to forgo immediate returns in favor of maximizing long-term shareholder value and short-term shareholders such as activist hedge funds merely seeking to "profit from fluctuations in stock price, without regard to whether those fluctuations will become permanent."[284] In terms of social welfare, critics describe hedge

[281] *See* summary of empirical studies of shareholder activism presented in Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism*, 19 J. APPLIED CORP. FIN 55, 61-62, 66-67 (2007) (concluding that the results of studies of the long-term stock performance of targeted companies have been mixed and that virtually all studies of long-term operating performance have reported no statistically significant changes in the operating performance of targeted companies.)

[282] Bebchuk, Brav & Jiang, *supra* note 228, at 1130 (also noting that "the market does not fail to appreciate the long-term consequences of activism as insulation advocates fear it does. Rather, the stock appreciation accompanying activists' initial announcement reflects the market's correct anticipation of the intervention's effect, and the initial positive stock reaction is not reversed in the long term.")

[283] Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders,* 60 STAN. L. REV. 1255, 1290 (2008).

[284] Iman Anabtawi, *supra* note 262, at 579.

fund activism as "at best" "nonproductive rent-seeking" and "at worst" a practice that "drains companies of resources they need for a healthy future."[285] However, it may be that most shareholder conflicts can be overcome, as hedge funds ordinarily need the support of long-term shareholders in order to succeed in their campaigns.[286] This is especially the case at larger companies, where hedge funds necessarily own a smaller percentage of the stock. It is also increasingly the case with the rise of index investment and the concentration in power among asset managers.[287]

E. Short-Termism and Agency Costs

It is undeniable that the most vocal criticism of hedge fund activism is short-termism, whether that be through the narrative repeated in politics and the media, or through a more thorough academic analysis of the incentives of activist hedge funds and corporate boards of directors. Therefore, it would be unusual for an assessment of hedge fund activism to take place without a discussion on short-termism. Although some commentators argue that short-termism is not a problem, or that short-term goals are not necessarily incompatible with the long-term success of the corporation, to ignore the short-termist critique would leave any analysis open to immediate criticism in terms of hedge funds' potential short-term orientation.

The most common counter argument is to emphasize the virtues of hedge fund activism in terms of shareholder democracy reducing shareholder-manager agency costs. As highlighted earlier, drawing attention to management excess or corporate fraud is key to the narrative that hedge fund activists themselves promote in their public statements about their target companies. The later stages of this thesis therefore consider whether certain types of hedge fund activism can better mitigate agency costs but also whether activist board representation can also be a solution, rather than a problem with regard to the short-termism narrative and critique.

[285] Anabtawi & Stout, *supra* note 283, at 1292.
[286] Kahan & Rock, *supra* note 255, at 1027.
[287] *See infra* Chapter 5.

Conclusion

Part I considered key problems in corporate governance from an alternative perspective. While most critical work on hedge fund activism considers the phenomenon in light of how to minimize agency problems and bridge the separation of ownership and control, a different approach was taken. Rather than centering the analysis around the issue of mitigating stealing and shirking, a focus was shone on other key problems that have arisen since the monitoring board was first devised as a solution to the shareholder-manager agency problem. The most pressing issues facing corporations, boards, and shareholders in the twenty-first century revolve around negative corporate externalities and short-termism. Indeed, it is these problems that are thought to fuel both the climate crisis and the financial crisis. The analysis therefore focused on how suitable independent directors on the monitoring board are in confronting these particular challenges. Boards are certainly facing heightened expectations from shareholders and stakeholders, and it seems likely that the board will need to further evolve in response to these challenges. Activist hedge fund campaigns vividly expose some of the deficiencies of the independent monitoring board. Indeed, directors appointed by activist hedge funds are specifically chosen to overcome these deficiencies. Activist directors are well-informed, well-resourced, and are proactive in sustainable value creation. This suggests that there may be a shift away from the traditional monitoring board model, as activist directors become involved in corporate strategy and operations, a function that independent directors may be ill-resourced to fulfil. Board composition and function may need to change to meet increased standards. Given the heightened expectations on boards, the next generation of the corporate board may need to emulate some of the approaches taken by activist directors such as becoming involved in strategy and management. Essentially, the lesson from activist appointed directors is that boards may need to focus more on sustainable value creation. They may need to become more proactive in generating value and addressing ESG issues, rather than reactive only to corporate crises. The lesson from the discussion on the short-termism narrative is that we should be open to learning from the beneficial aspects of hedge fund campaigns, as opposed to denouncing all campaigns as short-termist.

These discussions link to Part II of the thesis which examines the rise in activist board representation. This increasingly common phenomenon may signal that boards are not

succeeding in meeting the expectations of shareholders and stakeholders. The theory, hypotheses and empirical study that follows in Part II investigates activist board representation at S&P 500 companies.

PART II – Activist Board Representation

Introduction

In 2014, the activist hedge fund Starboard Value made history by succeeding in its campaign to replace the entire board of an S&P 500 company, Darden Restaurants.[288] Described as the "ugliest shareholder revolt of 2014,"[289] Starboard's strategy for Darden was contained in a public 294-page white paper, which explained in intricate detail how the activist hedge fund planned to execute a turnaround of the company, particularly with regard to deficiencies in strategy and operations at the underperforming Olive Garden restaurant chain.[290] Starboard's campaign began following the frustration of other Darden shareholders, who had contacted the hedge fund to persuade it to invest in and target the company.[291] Despite holding less than 10% of the shares in Darden, Starboard's campaign culminated in the activist hedge fund securing sufficient shareholder votes to replace all of Darden's incumbent board with twelve new nominees. Ten of the nominees were seasoned executives who had expertise in the food and drinks industry or in corporate turnarounds, who were not affiliated with the hedge fund. The elected slate also included two representatives from Starboard – its founder, Jeff Smith, and its head of research. The change in leadership at Darden appeared to result in a very effective turnaround, with the company's share price rising by nearly 60% in the 18 months following the hedge fund's intervention.[292]

Boardroom coups initiated by shareholders, such as Starboard's campaign at Darden, are extremely rare events. Indeed, this campaign was the first and last time (to date) that an activist hedge fund took complete control of an S&P 500 company's board in the United

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[288] Stephen Foley, *Starboard sweeps away entire Darden board*, FIN. TIMES (Oct. 10, 2014) https://www.ft.com/content/1be89158-5086-11e4-9822-00144feab7de.

[289] Lex team, *Darden Restaurants: back for seconds*, FIN. TIMES (Mar. 25, 2015) https://www.ft.com/content/50d307f2-d260-11e4-9c25-00144feab7de.

[290] STARBOARD VALUE, TRANSFORMING DARDEN RESTAURANTS (2014), http://www.shareholderforum.com/dri/Library/20140911_Starboard-presentation.pdf.

[291] Owen Walker, Barbarians in the Boardroom: Activist Investors and the Battle for Control of the World's Most Powerful Companies 49 (2016).

[292] Michael J. de la Merced, *Starboard Value's Rise to Activist Prominence*, N.Y. TIMES DEALBOOK (Apr. 27, 2016) https://www.nytimes.com/2016/04/28/business/dealbook/starboard-values-rise-to-activist-prominence.html.

States. However, less extreme examples of minority board representation by activist hedge funds are much more commonplace.

This Part II examines the evolution of hedge fund activism, in particular the phenomenon of activist board representation campaigns. Chapter 3 discusses the theory on activist board representation, examines some prior empirical studies on hedge fund activism more generally, and develops several hypotheses about how activist board representation might be different to other types of hedge fund activism. Chapter 4 then tests the various hypotheses developed in Chapter 3 through an empirical study analyzing activist board representation campaigns at S&P 500 companies from 2010 to 2019. A summary of the results of my empirical study is presented below, for ease of reference.

Summary of Results

Sample

- 165 S&P 500 companies were actively targeted by at least one activist hedge fund during the ten-year sample period from 2010 to 2019. There were 228 activist-target event pairs in the sample, as various companies were targeted by multiple activist hedge funds or were targeted more than once by the same hedge fund.
- Schedule 13Ds were filed in 99 activist campaigns (43.4% of the sample) and no Schedule 13D was filed in 129 activist campaigns (56.6% of the sample).

Activist Board Representation Campaigns

- There were 126 activist board representation campaigns at 101 unique companies and 102 non-board level campaigns at 85 unique companies.
- Generally activist board representation campaigns are becoming more common at S&P 500 companies. There was a steady increase in the number of activist board representation campaigns at S&P 500 companies from 2010 until 2015, followed by some slight decreases from 2016 to 2019 (although the number of campaigns remain above 2010 to 2013 levels).
- Overall, 55% of campaigns in the sample involved the activist hedge fund seeking board representation (49% of campaigns in the first half of the decade and 60% in the

second half of the decade). Activist board representation campaigns are therefore more prevalent in the S&P 500 than non-board level campaigns.

- Activist board representation campaigns were almost always at least partially successful (success being defined in terms of the activist hedge fund securing at least one board seat). The overall success rate of campaigns was 87%. In only 16 out of the 126 activist board representation campaigns (13%) did the hedge fund fail to secure any board seats at all.
- Activist board representation campaigns at S&P 500 companies are conducted by a limited number of activist hedge funds. Only thirteen activist hedge funds initiated more than one board representation campaign at an S&P 500 company and six activist hedge funds were responsible for more than two-thirds of all activist board representation campaigns. A wider group of activist hedge funds conduct non-board level campaigns.

Investment Horizon

- The average investment period of *exited* activist board representation campaigns (where the hedge fund was successful in securing at least one seat on the board) is 3 years 1 month, with the median being 2 years 11 months.
- Assuming a cut-off date of 30 June 2022, the average investment period of *ongoing* activist board representation campaigns (where the hedge fund was successful in securing at least one seat on the board) is 5 years and 9 months, with the median also being 5 years 9 months.
- Overall, the average investment period of activist board representation campaigns is *at least* 3 years 8 months, with the median being *at least* 3 years 4 months. This underestimates the overall duration of campaigns as 22% of campaigns are still ongoing.
- The average investment period of *exited* investments for non-board level campaigns is only 19 months, with the median being 15 months.
- Assuming a cut-off date of 30 June 2022, the average investment period of *ongoing* non-board level campaigns is only 21 months, with the median being 15 months. These figures are closer to the average investment durations found in earlier empirical studies on hedge fund activism.

- Some activist board representation campaigns are long-term. For 20% of the companies targeted, the activist hedge fund was (or has been) invested in the target company for more than five years. This is considerably different activist behavior to that traditionally associated with activist hedge funds.
- Some activist hedge funds tend to focus more on longer-term investments than others, a prominent example being Trian Fund Management which has been invested in 50% of its target companies for more than five years.

Capital Commitment

- The average size of investments for successful activist board representation campaigns is 6.35% of the shares, or a median of 6.37%.
- The average size of investments for non-board level campaigns is 3.65% of the shares, or a median of 2.80%.

Campaign Objectives

- Activist board representation campaigns and non-board level campaigns generally have similar levels of financial or balance sheet activism.
- Strategic and operational activism is almost always accompanied by a request for activist board representation. It is uncommon for activist hedge funds to pursue this type of activism without also requesting at least one board seat.
- Activist board representation campaigns and non-board level campaigns generally have similar levels of M&A activism. The only category of M&A activism where there is a notable difference is for spin-offs or sales of business divisions. Here, 37.4% of activist board representation campaigns were accompanied by requests for spin-offs, compared to 23% of non-board level campaigns.
- For governance activism, activist hedge funds are much more likely to campaign to replace the CEO when they are requesting board representation (27% of activist board representation campaigns compared to only 4% of non-board level campaigns).

CEO Turnover

- At 56% of companies where the activist secured board representation, the CEO was replaced at least once during the activist's tenure. In non-board level campaigns, the CEO was replaced at 17% of companies during the activist's tenure.
- At 46% of companies where activists were successful in securing board seats, the CEO stood down within one year of the board seat(s) being granted. For non-board level campaigns, 13% of CEOs exited within one year of activist involvement. The latter is more in line with baseline CEO turnover.

Types of Activist Director

- 34% of board seats went to directors affiliated with the activist hedge funds, with 66% of board seats going to non-affiliated directors. In the more recent years of the sample, the proportion of affiliated directors being appointed has generally decreased. The clear trend is therefore towards non-affiliated director nominees as opposed to hedge fund principals themselves taking seats on boards.
- This trend does vary by hedge fund e.g., Trian Fund Management and ValueAct Capital always appointed at least one affiliated director on the board. Elliott Management always exclusively appointed non-affiliated directors.
- Activist hedge funds tend to stay invested in target companies longer when there is at least one affiliated director on the board.

Activist Settlements

- 85% of campaigns for activist board representation were settled. Only 6% of the board representation campaigns proceeded to a proxy contest (eight events at seven companies). Proxy contests are therefore rare in the S&P 500.
- In terms of actual number of seats gained, only 6.5% of board seats were secured via a proxy contest, compared to 93.5% of board seats being secured via negotiated settlement agreements.

Chapter 3 – Activist Board Representation: Theory & Hypotheses

I. THE EVOLUTION OF HEDGE FUND ACTIVISM

Proxy contests are not a new concept. Beginning in the 1950s, there were various high-profile battles for the control of companies in the United States.[293] However, hedge fund activism did not become a fundamental part of U.S. corporate governance until the 2000s[294] and activist board representation is an even more recent phenomenon. John Armour and Brian Cheffins draw a distinction between "offensive" and "defensive" shareholder activism, with hedge funds representing the archetypal offensive shareholder activist.[295] Activist hedge funds identify target firms and purposefully invest in them to pursue an activist agenda, whereas other institutional investors tend to be reactionary and will usually only engage in activism to protect existing holdings.

However, as discussed in Chapter 2, activist hedge funds have consistently been criticized for being short-termist. In particular, they are accused of engaging in financial wizardry rather than making substantive long-term improvements to target company strategies and operations. Despite the existence of empirical studies which argue that hedge fund activists create long-term as well as short-term value, the popular narrative is still that they are short-term actors. For example, as recently as 2017, Leo Strine argued that "the stories behind the empirical data cited by hedge fund activists seem to mostly involve financial engineering…the scholars have not yet put names of companies to the data, to show how the hedge fund has improved corporate operations in a durably valuable way.[296]

This Part seeks to explore this narrative and whether it accurately reflects modern day hedge fund activism. It discusses various reasons why hedge fund activism may have evolved from the traditional short-termist perceptions of activist hedge fund behavior, and

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[293] *See* John Armour & David A. Skeel Jr., *Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation*, 95 GEO. L. J. 1727, 1752 (2007) (for a discussion of the Young proxy contest for the control of the New York Central Railroad in 1954). *See also* John Armour & Brian Cheffins, *Stock Market Prices and the Market for Corporate Control*, U. ILL. L. R. 761, 781 (2016) (between 1900 and 1965 the authors identified 398 proxy contests where the protagonists were seeking to obtain control of the board.

[294] Brian R. Cheffins & John Armour, *The Past, Present and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 102 (2011) (for a history of the direct antecedents to activist hedge funds see 75-81).

[295] Cheffins & Armour, *supra* note 294, at 56-57.

[296] Strine, *Who Bleeds*, *supra* note 1, at 1953.

empirically tests whether some forms of activism such as activist board representation may be more long-term in orientation. Essentially, what the critics take issue with is activist hedge funds engaging in what is sometimes termed "balance sheet activism", which involves quick returns of cash to shareholders through increased dividends or share buybacks. Anecdotal evidence has shown, however, that activist hedge funds can often become much more involved in company strategy and operations than the financial wizardry critics suggest. Starboard Value's campaign at Darden is just one example of an activist hedge fund submitting a lengthy white paper analyzing the deficiencies in corporate strategy and operations. Therefore, my empirical study seeks to analyze more systematically the types of activism that hedge funds are now engaging in at the biggest companies in the United States.

II. RESEARCH QUESTIONS AND HYPOTHESES

This Section presents the research questions that motivated this empirical study and develops the hypotheses that are then tested in the study. Overall, the project seeks to explore the evolution of hedge fund activism and whether activist board representation is associated with fundamentally different types of behavior on the part of activist hedge funds, compared to cases where the funds do not seek or secure board representation.

A. Prevalence of Activist Board Representation

Research Question 1 – Is activist board representation becoming a more common form of hedge fund activism?

The first research question stated above explores whether activist board representation is becoming more prevalent. Anecdotal evidence suggested that it is, but my empirical study seeks to explore this more systematically. Historically, when hedge fund activism rose in popularity in the 2000s, board representation was a common campaign objective pursued by activist hedge funds. For example, a study conducted by Alon Brav, Wei Jiang, Frank Partnoy and Randall Thomas examined activist hedge fund campaigns from 2001 to 2006. They discovered that 24.8% of activist campaigns pursued at target companies in the

United States involved activist hedge funds seeking board representation.[297] In Brav, Jiang, Partnoy and Thomas' sample, these campaigns were split into cases where the activist hedge fund sought board representation without a proxy contest or confrontation with existing management (11.6% of events) and cases where the hedge fund launched a proxy contest in order to replace board directors (13.2% of events).[298] Another empirical study conducted around the same time by April Klein and Emmanuel Zur, which focused on a sample of campaigns conducted between 2003 and 2005, found that 27% of campaigns in their sample involved a request for a change in the board of directors' composition (41 out of 151 events).[299] Finally, in Bratton's study, it was noted that larger targets (large and mid-capitalization companies) predominated in the cash payout and asset sale groups, and were underrepresented when it came to board representation or proxy contests, with only 18% of large or mid-cap firms surrendering board seats.[300] Bratton uses this datapoint to make the argument that large firms could afford to pay off activists and return to normalcy, rather than having to surrender board seats.[301]

Although none of the studies specifically focus on the S&P 500, it seems highly likely that prior to 2010, activist board representation campaigns were uncommon at S&P 500 companies. No previous empirical study specifically analyzes activist board representation prior to 2010. However, some relevant data can be extracted from prior literature on hedge fund activism more broadly. For example, Bebchuk, Brav, Jiang and Keusch author a paper analyzing settlement agreements between hedge fund activists and target companies from 2000 to 2013.[302] The events in their dataset were mainly identified through Schedule 13(d) filings, but were also supplemented with news searches to identify activists who launched public campaigns with stock ownership below 5%.[303] In their appendix, they separate out "notable activist campaigns" that took place at large target companies with at least $7 billion in market capitalization.[304] Analyzing this data reveals that there were

[297] Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1743.
[298] *Id.*
[299] Klein & Zur, *supra* note 277, at 197.
[300] Bratton, *supra* note 272, at 1416.
[301] *Id.*
[302] Lucian A. Bebchuk, Alon Brav, Wei Jiang & Thomas Keusch, *Dancing with Activists*, 137 J. FIN. ECON. 1, 4 (2020) [hereinafter *Dancing with Activists*].
[303] Bebchuk, Brav, Jiang & Keusch, *Dancing with Activists*, *supra* note 302, at 4.
[304] Bebchuk, Brav, Jiang & Keusch, *Dancing with Activists*, *supra* note 302, at 35. An analysis of the authors' data reveals that they only identified six activist settlements at S&P 500 companies where activist hedge funds secured the appointment of new directors in the 10-year period from 2000 to 2009 (Time

only six cases between 2000 and 2009 where S&P 500 companies concluded settlement agreements with activist hedge funds for board representation. This data does not include *unsuccessful* attempts at board representation (as it only analyzes settlement agreements between activists and target companies), and it also excludes cases involving proxy contests that went to a shareholder vote (again, as it only considers negotiated settlements). Nevertheless, this is useful data, especially if many or most activist board representation campaigns result in settlement in any event.[305]

Further evidence of the incidence of activist board representation campaigns at S&P 500 companies prior to 2010 can be found in an empirical study by William Bratton analyzing activist campaigns from 2002 until mid-2006.[306] Here, hedge fund activist events from 2002 to 2006 were analyzed, and only nine out of 114 target companies (8%) were constituents of the S&P 500. Activists secured board representation at two of those companies (22% of the S&P 500 companies targeted).[307] Combining these sources of data from these two prior empirical studies only results in eight identified cases of activist board representation at S&P 500 companies from 2000 to 2009.

Reports from industry have also suggested that activist board representation may be on the rise. For example, a report by Lazard highlighted that 2016 was a record year for activist hedge funds succeeding in placing nominees on corporate boards in the United States. In the report, it was noted that activist hedge funds gained 131 board seats in total from 149 campaigns to secure board representation.[308]

Research Question 2 – Is activist board representation becoming a more successful form of hedge fund activism?

A related research question concerns how successful activist board representation campaigns are, with the caveat that reporting success rates is problematic as they are

Warner/Icahn in 2006, Home Depot/Relational Investors in 2007, Motorola/Icahn in 2008, Yahoo/Icahn in 2008, Sara Lee/ValueAct Partners in 2008 and Intuit/Relational Investors in 2009).

[305] *See infra* Section II. G.

[306] *See* Bratton, *supra* note 272.

[307] *See* Bratton, *supra* note 272, at 1429-1432. The relevant target company/hedge fund pairs were Massey Energy/Third Point in 2006 and H. J. Heinz/Trian Partners in 2006. It should be noted that this

[308] LAZARD, REVIEW OF SHAREHOLDER ACTIVISM IN 2016, 1, cited in Coffee, Jackson, Mitts & Bishop, *supra* note 320, at 386.

endogenous to the underlying engagement choices. The study by Brav, Jiang, Partnoy and Thomas does not report the number or percentage of such campaigns that ultimately led to activist hedge funds actually securing board representation. The authors do report the success rate for activist hedge fund events generally, which was 40.6% (where success was defined as the activist hedge fund achieving its main stated goals).[309] However, this figure was not broken down to report the success rate for board representation campaigns. In a more recent working paper surveying activist hedge fund data from 1994 to 2018, Alon Brav, Wei Jiang and Rongchen Li note that "in close to half of proxy contests, the dissident wins at least one seat".[310] However, this averages the results from campaigns in recent years with campaigns in the 1990s and 2000s, which is not useful for assessing the evolution of hedge fund activism. The Klein and Zur study did report success rates of different types of campaign strategy. Here, they noted that hedge funds generally enjoyed a 60% success rate overall in their campaigns, but that they succeeded in achieving board representation in 73% of campaigns (or 30 out of 41 attempts).[311] Overall, this translated into activist hedge funds achieving board representation at slightly less than 20% of the companies in the sample (30 out of 151 events).[312] At the time, Klein and Zur noted that their findings ran counter to evidence presented by Bebchuk that "U.S. shareholders' ability to replace the board of directors is 'largely a myth'".[313] Klein and Zur also noted, however, that the success rate of activist hedge funds securing board representation was lower than the success rate for financial activism. Indeed, in their sample activist hedge funds had a 100% success rate in getting the target company to buy back its own stock or initiate a cash dividend.[314] The success rate of financial activism was therefore higher than the success rate of activist board representation, meaning that other forms of activism were even less successful and brought the overall average success rate for all campaigns down to 60%. Although the sample size used in this study was relatively small, this finding is consistent with the view that in the early to mid-2000s, financial or balance sheet activism

[309] Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1744.
[310] Alon Brav, Wei Jiang & Rongchen Li, *Governance by Persuasion: Hedge Fund Activism and Market-based Shareholder Influence*, 9 (Eur. Corp. Governance Inst. Fin., Working Paper No. 797/2021, 2022), https://ssrn.com/abstract=3955116 [hereinafter *Governance by Persuasion*]
[311] Klein & Zur, *supra* note 277, at 211.
[312] *Id*.
[313] Klein & Zur, *supra* note 277, at 214 (citing Lucian A. Bebchuk, *The myth of the shareholder franchise*, 93 VA. L. REV. 675 (2007)).
[314] Klein & Zur, *supra* note 277, at 211.

was a more prevalent and a more successful strategy than seeking activist board representation.

The above research questions and discussion leads to the following hypotheses:

Hypothesis 1 – Activist board representation campaigns are increasingly prevalent at S&P 500 companies.

Hypothesis 2 – Activist board representation campaigns are increasingly successful at S&P 500 companies.

While early activist hedge fund campaigns may have focused more on financial or balance sheet activism, it is explored here whether activist board representation has become a strategy of choice at the largest companies in the United States, especially among the largest companies and the most formidable activist hedge funds. It is also investigated how successful these campaigns are.

It is important to caveat that the samples contained in the empirical papers described above generally did not include many large companies, such as S&P 500 companies. My empirical study detailed in Chapter 4 focuses on S&P 500 companies. Such companies were rarely targeted in the 2000s, with activist hedge funds generally focusing on smaller corporate targets. Therefore, the findings could be considerably different to those previously reported in any event.

There are several potential reasons why we might expect that there be more campaigns focusing on board representation now, compared with the earlier examples of hedge fund activism.

1. Low Hanging Fruit

First, there is some evidence to suggest that in the 2000s, activist hedge funds may have focused on "low-hanging fruit", for example by targeting cash rich companies that could quickly and easily redistribute cash to shareholders.[315] In Bratton's empirical study, it was

[315] Bratton, *supra* note 272, at 1394-95.

noted that the results "imply that the activists grabbed low-hanging fruit in the first three years [2002-2004], searching thereafter among a depleted stock of prime targets".[316] So, even by the end of 2004, it seems that such targets were less readily available than they had been at the beginning of the decade. Moreover, in a more recent review of the empirical evidence, Alon Brav, Wei Jiang and Rongchen Li noted that "under-performing firms with cash flow problems were low-hanging fruit for the first generation of activist investors while in the post-financial crisis period hedge funds have had to identify targets with issues that are not associated with the traditional fundamental performance metrics such as ROA".[317] Perhaps these types of target companies with excess cash balances are less common in the present day. This could be for a number of reasons, including that there is a prominent activist defense industry of advisors who help to ensure that companies are less vulnerable to being targeted by activist hedge funds. Therefore, opportunities to target cash rich "low-hanging fruit" may be less plentiful nowadays. There is also the issue that institutional investors and other longer-term shareholders may be reluctant to support such tactics on the part of activist hedge funds, especially if they are perceived as short-term financial engineering that would ultimately harm long-term shareholders. Instead, the activist hedge funds may be forced to gravitate towards more substantive forms of activism such as campaigns involving strategic and operational change.

2. Institutional Investor Support

Second, as alluded to above, substantive activist strategies may be more palatable to long-term institutional investors than financial engineering or balance sheet activism. It has always been the case that activist hedge funds cannot succeed in their campaign goals alone. They generally have a minority stake in a company – often less than a 10% shareholding – which means that they rely on the support of other investors to succeed in their campaigns. This support comes principally from institutional investors rather than retail investors, as institutions are the biggest shareholders at most public companies. Financial or balance sheet activism is usually not appealing to long-term institutional investors, so such investors may object to activist hedge fund interventions of this nature. For example, State Street Global Advisors recently stressed that they had "identified

[316] Bratton, *supra* note 272, at 1395.
[317] Brav, Jiang & Li, *Governance by Persuasion*, *supra* note 310, at 33.

certain actions as potential red flags for long-term investors as they raise questions about the motivations behind the actions and potential implications for sustainable value creation."[318] One red flag identified was "[f]ocusing on financial engineering such as share buybacks, leveraged dividends, spin-offs and M&A, which could add value in the short term but may also undermine long-term value."[319] Therefore, it is clear that outwardly institutional investors are less likely to support activist campaigns that focus on financial activism, as opposed to campaigns that at least appear to focus on more substantive long term value creation. Hedge fund activist board representation may be more appealing to long-term institutional investors if they perceive it as demonstrating a longer-term commitment on the part of the activist hedge fund, or a more substantive contribution to value creation at the company. Whether institutional investors support activist board representation campaigns could potentially depend a lot on the identity of the proposed director nominees.

Activist hedge funds are repeat players so the success of their campaigns matters for their reputation and the potential success of future campaigns. Therefore, if they can tailor their strategies to ensure that long-term institutional investors are supportive of their campaigns, then that is beneficial.

3. A Means to an End

Third, activist board representation could simply be viewed as a means to an end or as an intermediary step that is needed for activist hedge funds to achieve other goals. Commentators have long argued that activist hedge funds primarily aim to increase the value of their shares. Indeed, there are various different tactics that activist hedge funds can use to try to improve the stock price of a target company. Some of these tactics are entirely feasible to implement from outside of the boardroom. The primary example is financial or balance sheet activism which can involve increased dividends or share buybacks. A board seat is unlikely to be necessary for the activist hedge fund to push through such a change. Similarly, it may be possible to obtain a takeover premium for the shares by putting the target company into play as a takeover target. However, if the

[318] State Street Global Advisors, *Protecting Long-Term Shareholder Interests In Activist Engagements*, (Apr. 2020 historical reprint), 2, https://www.ssga.com/library-content/pdfs/ic/protecting-long-term-shareholder-interests.pdf.
[319] *Id.*

fundamental problem at a company is its strategy or operations, it may be difficult for an activist hedge fund to effect change from outside of the boardroom. Although hedge funds can potentially try to pursue these other types of activism without having the benefit of one or more board seats, having access to the board can expedite progress towards their desired goals and render their campaigns more likely to succeed. Some types of activist interventions – such as strategic or operational activism – are likely to be much more effective if the activist hedge fund has at least one board seat which gives the fund access to strategic discussions. Without board representation, it may be difficult for activist hedge funds to ensure that their value-creating strategies are being effectively implemented. Therefore, we might simply see an increase in activist board representation because it is *necessary* in order for activist hedge funds to achieve campaign goals relating to corporate strategy or operations. Similarly, if an activist hedge fund seeks to replace the CEO or remove other managers, board representation can also give activist directors positions on key board committees and therefore give them a role in choosing the next CEO of the company. Another related benefit of a board seat, as outlined below, is the potential access to inside information that such a board seat will afford the activist hedge fund. This can be particularly useful for changes to strategy and operations.

Bebchuk, Brav, Jiang and Keusch have made a similar "means to an end" argument to rationalize their analysis of settlement agreements between hedge fund activists and target companies. Here, the evidence showed that settlement agreements tend to focus on changes in board composition as opposed to containing any specific agreement to implement the type of operational changes that activists ultimately seek.[320] However, the analysis also demonstrated that settlements were often followed by major changes that were not specifically contracted for in the agreement itself, such as increases in CEO turnover, increased payouts to shareholders, and a higher likelihood of a sale or going-private transaction.[321] Therefore, activist board representation may be a necessary or effective precondition to activists implementing these types of changes at target companies.

[320] Bebchuk, Brav, Jiang & Keusch, *Dancing with Activists*, *supra* note 302, at 2, 12-17. There are various legal reasons why this may be the case. *See* John C. Coffee Jr., Robert J. Jackson Jr., Joshua R. Mitts & Robert E. Bishop, *Activist Directors and Agency Costs: What Happens When an Activist Director Goes on the Board?*, 104 CORNELL L. REV. 381, 397 (2019) (noting that "directors, as fiduciaries, cannot contract away their discretion").
[321] Bebchuk, Brav, Jiang & Keusch, *Dancing with Activists*, *supra* note 302, at 3, 25-30.

4. Access to Information

Another primary motivator for activist hedge funds to seek board representation may be the access to confidential information that a board seat gives them.[322] Once hedge funds secure board representation, they have access to confidential company documents and data that they would not otherwise be able to access. Activists are also sometimes given board observer status in settlement agreements, which shows that access to the board and the associated information that status provides is valuable to hedge fund activists even if formal board representation is not secured.

The issue of activists and information asymmetry is multifaceted. As noted earlier in Chapter 1, activist hedge funds can help to *address* the informational challenges faced by independent directors on the monitoring board. Kastiel and Nili described this as overcoming the "informational capture" of the board, as activist hedge funds have the resources to collect and analyze a vast amount of information and activist appointed directors can rely on their "back office" at the hedge fund to enable them to contribute more substantively to the company's strategy.[323] Therefore, activist appointed directors can *contribute* information and thus strategies to the rest of the board. At the same time, activist hedge funds may want board access in order to *obtain* inside information from management. Hamdani and Hannes argue that the primary benefit to a hedge fund of activist appointed directors is that these directors gain access to the company's non-public information and are able to share this information with the larger activist hedge fund. The hedge fund can then further analyze the information and help to formulate strategies.[324] Therefore, there can be a two-way information flow.

However, there is a potential "dark side" associated with activist hedge funds having access to confidential inside information. Coffee, Jackson, Mitts and Bishop go so far as to argue that hedge fund activism, and in particular wolf pack activism, may be fueled by

[322] Another way that activists can obtain information is by a "220 demand" which refers to the right of a shareholder, under §220 of the Delaware General Corporation Law, to examine certain corporate books and records for any proper purpose. *See* Sujeet Indap, Sh*areholders win a new legal tool to challenge M&A deals*, FIN. TIMES (Feb. 12, 2018) https://www.ft.com/content/bb2ed60a-0d39-11e8-839d-41ca06376bf2.
[323] Kastiel & Nili, *supra* note 18, at 63-64; Assaf Hamdani & Sharon Hannes, *The Future of Shareholder Activism*, 99 B. U. L. REV. 971, 995 (2019).
[324] Hamdani & Hannes*, supra* note 323, at 995.

subsidies caused by access to material, non-public information.[325] In an analysis of 475 private settlement agreements from 2000 to 2015, the authors discovered that once an activist-nominated director joins a target board pursuant to a settlement agreement, an abrupt pattern of "information leakage" follows, with the result that the target company's share price begins to anticipate future public disclosures.[326] Therefore, the authors argue that new agency costs may arise from hedge fund activism and especially hedge fund managers joining target company boards.[327]

For all of the above reasons, it might be expected that we see more activist board representation campaigns in recent years, compared to the earlier years of hedge fund activism that were explored in the aforementioned empirical studies. The combination of there being less available target companies that would be classified as "low-hanging fruit", the likely institutional investor support for activist board representation campaigns, the fact that activist board representation may be a necessary precondition to engaging in strategic or operational activism, and the access to information that a board seat affords, may all be credible reasons why activism may have evolved to focus more on board representation. Therefore, more campaigns for board representation are likely, and it is predicted that these campaigns may often be successful, especially if there is widespread institutional investor support for such campaigns.

B. Investment Horizon

Chapter 2 explored in depth the narrative that activist hedge funds are short-term actors. Leo Strine has noted that "[t]he rise that most hedge funds seek must occur within a relatively short time period, because many activist hedge funds have historically retained their positions for only one to two years at most."[328] However, activists themselves have emphasized that they take longer-term positions in companies when they secure board representation. For example, Jeffrey Ubben, the former head of ValueAct Capital, noted that in firms where it has board seats, ValueAct holds its positions for two to four years.[329]

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[325] Coffee, Jackson, Mitts & Bishop, *supra* note 320, at 389-90, 434-35, 439.
[326] Coffee, Jackson, Mitts & Bishop, *supra* note 320, at 382, 386-37, 389, 408-434, 455.
[327] Coffee, Jackson, Mitts & Bishop, *supra* note 320, at 385.
[328] Strine, *Who Bleeds*, *supra* note 1, at 1892.
[329] *An investor calls*, THE ECONOMIST (Feb. 5, 2015) https://www.economist.com/briefing/2015/02/05/an-investor-calls.

Similarly, Nelson Peltz, the founder of Trian Partners has stated that "[w]e are accused of being short term investors. But the average length of stay in an investment is five years. At Fidelity it's 18 months".[330]

Previous empirical studies have estimated the average or median investment duration of activist hedge fund campaigns. In Brav, Jiang, Partnoy and Thomas' study of activist events from 2001 to 2006, which is most often quoted, the median investment period for completed activist hedge fund interventions was approximately one year, with an overall duration of all the events (including those that were ongoing and had not been exited yet) being closer to 20 months.[331] This figure is quoted in much of the subsequent literature on hedge fund activism to illustrate the point that activist hedge funds are short-termist and will rarely stay invested in target companies beyond two years. The other key studies released in the 2000s did not specifically measure investment duration. One other study that did is Nicole Boyson and Robert Mooradian's of activist campaigns between 1994 and 2005.[332] Here, they divide campaigns into three categories: communication only (or "investment purposes only"), communication then aggressive, and aggressive only. For communication only firms, they found that the mean duration of activist campaigns was about 1 and 1/3 years. For the other two categories, the average duration of the campaigns was longer, at just over 2 years.[333]

This leads to the third research question that is investigated in my empirical study in Chapter 4:

Research Question 3 – Is activist board representation associated with a longer-term investment approach on the part of the activist hedge fund?

The hypothesis relating to this question is as follows:

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[330] Kerry A. Dolan, *Trian's Nelson Peltz on Why He's a Nicer Investor than People Think*, FORBES (June 21, 2016) https://www.forbes.com/sites/kerryadolan/2016/06/21/trians-nelson-peltz-on-why-hes-a-nicer-investor-than-people-think/?sh=5742293b4f95 (cited in Strine, *Who Bleeds*, *supra* note 1, at 1892).
[331] Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1731-1732.
[332] Nicole M. Boyson & Robert M. Mooradian, *Corporate Governance and Hedge Fund Activism*, 14 REV. DERIV. RES. 169 (2011).
[333] Boyson & Mooradian, *supra* note 332, at 175, 178-79.

Hypothesis 3 – Activist hedge funds that successfully secure board seats are likely to stay invested in target companies longer than activists without board seats.

There are various intuitive and legal reasons why this may be the case. Intuitively, if the activist is seeking board representation to propose strategic and operational changes while on the board, then these strategies are likely to take longer to implement and produce results, compared to returns of cash to shareholders where the impact is much more immediate. Another potential reason activist hedge funds might adopt a longer-term perspective when they seek and secure board representation is a regulatory one. In the United States, a hedge fund will become an "insider" that is subject to Section 16 of the Exchange Act if it has a 10% stock ownership or a representative on the company board under the SEC's "director by deputization" theory.[334] As a result, the activist would have to disclose any change in its interest and would have to disgorge any profits from "short-swing" trading, i.e. trading within any six-month period. This imposes some practical limitations on hedge funds selling stock. There may also be restrictions on selling stock in settlement agreements that are negotiated between activist hedge funds and target companies. For example, in some settlement agreements it is a condition that the activist continues to hold a certain stake in the target company in order to retain its seat on the board.[335]

C. Capital Commitment

Relatedly, it might be expected that activist hedge funds would commit more capital to a target company when they have board seats, reflecting their increased commitment to the company for the longer-term.

[334] Securities Exchange Act of 1934 § 16, (codified as amended at 15 U.S.C. § 78p (2012)). Cases on "director by deputization" may take into account the following factors, among others: the director regularly shares confidential information with the investor; the director has a relationship with the investor that allows the investor to influence the director's decisions; the director has a relationship with the investor that allows the director to routinely influence the investor's investment policy generally or with respect to the issuer; or the director performs his or her duties for the benefit of the investor rather than for the issuer.

[335] An example of this from the United Kingdom is ValueAct's settlement agreement with Rolls Royce, where the activist hedge fund could only retain its seat on the board provided its stake in Rolls Royce did not fall below 10%. *See* Relationship Agreement between Rolls-Royce and ValueAct Capital (Mar. 2, 2016), https://www.rolls-royce.com/~/media/Files/R/Rolls-Royce/documents/about/Key-Terms-of-Relationship-Agreement-with-ValueAct.pdf.

The capital committed by activist hedge funds has been reported in previous studies, but this has never been broken down into cases where the activist hedge fund sought or secured board representation, and cases where it did not. In the study by Brav, Jiang, Partnoy and Thomas, the median maximum ownership stake held by activist hedge funds in the sample was 9.1%, with no distinction being made between different types of campaign.[336] This number is expected to be higher than in my sample, because it included all U.S. companies, not just the S&P 500. Similarly, in Bratton's study, the median percentage of stock held in small capitalization companies was 9.8%, whereas for large capitalization companies (over $5 billion in market capitalization) it was 6.7%.[337] Again this was not broken down into types of campaign. Primarily, I am seeking to discover whether activist hedge funds commit to a higher percentage of the target company's shares when they seek and secure board representation.

This leads to the fourth research question that is explored in the empirical study:

Research Question 4 – Do activist hedge funds hold larger stakes in the target company when they appoint activist directors, compared to cases where they have no board seats?

The hypothesis relating to this question is as follows:

Hypothesis 4 – Activist hedge funds that seek and secure board seats may also take a larger ownership stake.

D. Campaign Objectives

1. Strategy & Operations

There are anecdotal examples of activist hedge funds submitting detailed business plans and proposals for long-term strategic and operational improvements at target companies. One well publicized example was the proxy contest launched by Trian Partners to obtain one seat for its founder, Nelson Peltz, on the board of Proctor & Gamble ('P&G') in 2017. P&G, with a market capitalization of around $235 billion, was the largest company ever

[336] Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1732.
[337] Bratton, *supra* note 272, at 1389.

to be subject to a proxy contest.[338] Trian invested $3.5 billion in P&G, which gave the activist hedge fund a 1.5% stake in the company. P&G's shareholder base was somewhat unusual for an S&P 500 company as it has a more dispersed shareholder base than is commonly seen. P&G had around three million shareholders, and a high proportion of individual shareholders (generally employees or former employees). During the campaign, Trian put forward a 93-page whitepaper "Revitalize P&G Together"[339] which detailed the issues it sought to correct at P&G through its campaign. Unusually, Martin Lipton, a vocal opponent of hedge fund activism, highlighted that the P&G whitepaper was unique in many ways as Trian was seeking to promote sustainable long-term investment and growth, was not seeking to break up P&G, and was not seeking to cut pensions, reduce R&D, marketing expense or capital expenditures.[340] Additionally, Trian was not proposing to replace P&G's current CEO or replace any directors. P&G itself had already engaged in many of the techniques that hedge fund activists are traditionally criticized for, including layoffs, share buybacks, dividend increases and substantial cost cutting.

This anecdote serves to illustrate some of the theory motivating the next hypothesis. As demonstrated by the P&G whitepaper, activist hedge funds have the expertise and resources to conduct extensive research on target companies from outside of the boardroom. They can then present their proposals to management and to investors through their whitepapers. However, unlike financial or balance sheet activism, it would be very difficult for an activist hedge fund to implement any strategic or operational proposals from outside of the boardroom. Doing so requires access to the board and to management. Therefore, a board seat would seem to be a necessary precursor to executing any change of this nature.

Research Question 5– Do activist hedge funds pursue different types of strategies when they seek board representation?

[338] This was not P&G's first experience as the target of hedge fund activism. In 2013 it succumbed to pressure from Pershing Square to replace the Chairman and CEO of the company with the former Chairman and CEO. *See* Jessica Wohl, *Procter & Gamble brings back former CEO to fix company*, REUTERS (May 24, 2013) https://www.reuters.com/article/us-procter-ceo/procter-gamble-brings-back-former-ceo-to-fix-company-idUSBRE94M1AW20130524.

[339] TRIAN PARTNERS, REVITALIZE P&G TOGETHER, (Sept. 6 2017), https://trianpartners.com/wp-content/uploads/2017/01/Trian-PG-White-Paper-9.6.17-1.pdf.

[340] Martin Lipton, *The Trian/P&G Proxy Contest,* HARV. L. SCH. F. ON CORP. GOVERNANCE (Sept. 11, 2017) https://corpgov.law.harvard.edu/2017/09/11/the-trianpg-proxy-contest/.

Hypothesis 5a – Activist board representation may be accompanied by more substantive strategic and operational activist strategies rather than the financial engineering that activist hedge funds are commonly criticized for.

2. Balance Sheet Activism

Related to the general question posed in the fifth research question, my empirical study also investigates whether balance sheet activism is less prevalent in cases where activist hedge funds seek and secure board seats. Again, the intuition is that a strategy involving balance sheet activism would be less likely to accompany requests for board seats. There are several reasons for this. One is that if balance sheet activism were the only goal, it would not be necessary for the activist hedge fund to secure a board seat in order to succeed in its campaign. The company's cash position can be analyzed from outside of the boardroom and the activist hedge fund would not need special access to inside information in order to implement this strategy in practice. Rather, it would simply be a case of whether the company management were willing accede to this demand or not. Moreover, as noted earlier, longer term institutional investors may not be supportive of hedge funds pursuing financial or balance sheet activism as a primary campaign strategy, and it also may be the case that targets classified as low-hanging fruit in this respect are diminishing or non-existent. Overall, this leads to the following hypothesis:

Hypothesis 5b – Activist hedge funds may be less likely to engage in financial or balance sheet activism when they seek or secure board representation.

E. CEO Turnover

The next research question is as follows:

Research Question 6 – Are target company CEOs more often replaced when an activist hedge fund secures board representation?

Brav, Jiang, Partnoy and Thomas argued in 2008 that "hedge fund activism is not kind to CEOs of target firms".[341] In particular, they found in their study that during the year after

[341] Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1732.

an activist hedge fund campaign is announced, the CEO turnover rate increases by almost 10 percentage points, and average CEO compensation declines by approximately $1 million.[342] More recently, reports on activist campaigns by organizations such as Lazard have revealed that CEO turnover is higher at activist targets. For example, in a report by Lazard in 2017, it is noted that CEO turnover at activist targets averaged 23% compared to 12% for non-targets.[343] Similarly, the study by Bebchuk, Brav, Jiang and Keusch on activist settlement agreements outlines that although only 3% of settlement agreements provide for the CEO's departure as a contract term, 18.6% of CEOs depart within a year of the relevant settlement agreement.[344]

Logically, activist hedge funds may need a representative on the board and certain committees in order to contribute in a meaningful way to discussions for a replacement CEO. Therefore, intuitively it might seem likely that CEO turnover would be higher when an activist hedge fund seeks and secures board representation. This leads to the following hypothesis:

Hypothesis 6 – Activist board representation may be associated with CEO departures, as a board seat may be helpful for an activist hedge fund to successfully oust the CEO.

F. Types of Activist Director

Activist director nominees can either be affiliated directors who work at the activist hedge fund, or non-affiliated directors who are selected by the hedge fund, often due to their depth of business acumen in a particular industry or due to an impressive track record in executing corporate turnarounds. Studies on hedge fund activism in the early 2000s showed that it was much more common in the past for affiliated directors to be appointed. For example, in a dataset of activist campaigns from 2002 to 2006, it was noted that when activists gained seats on the board, 81% of those joining the board were activist fund principals with only 19% of directors appointed by activist hedge funds being non-affiliated.[345] More recent studies have continued to emphasize the prevalence of hedge

[342] *Id.*
[343] LAZARD'S SHAREHOLDER ADVISORY GROUP, REVIEW OF SHAREHOLDER ACTIVISM – Q3 2017, at 1 (2017), cited in Coffee, Jackson, Mitts & Bishop, *supra* note 320, at 388.
[344] Bebchuk, Brav, Jiang & Keusch, *Dancing with Activists*, *supra* note 302, at 16.
[345] Bratton, *supra* note 272, at 1412.

fund employees on director slates. For example, in a study conducted by Coffee, Jackson, Mitts and Bishop that analyzed 475 settlement agreements between target companies and activist hedge funds, they found that "[a]pproximately 70% of fund-nominated director slates include a hedge fund employee".[346]

There have been criticisms of activist hedge fund managers joining the boards of companies. One commonly asserted criticism is that activist hedge fund managers are highly unlikely to have a better idea of how to run a company than the incumbent directors.[347] It is argued that many activist hedge fund managers, perhaps expert in financial structuring and governance, may lack the experience of serve on a corporate board and may not have the industry expertise that is often required.[348] When seeking board representation and nominating directors, activist hedge funds have a choice whether to propose their own investment managers as candidates, or to put forward non-affiliated experienced industry executives. They often put forward a combination of the two, if they are seeking multiple board seats.

Another "dark side" of activist hedge fund managers themselves joining the board relates to the earlier critique by Coffee, Jackson, Mitts and Bishop regarding "information leakage". One of the main empirical findings of their study on activist settlements was that "the increased leakiness is strongly associated with the appointment of directors who are also employees of the activist investor as opposed to the industry experts typically appointed to the target's board pursuant to an activist settlement."[349]

Research Question 7 – Are most activist directors appointed by activist hedge funds affiliated with the hedge fund, or are they non-affiliated directors?

[346] Coffee, Jackson, Mitts & Bishop, *supra* note 320, at 382.
[347] *See* Stephen Bainbridge, *Preserving director primacy by managing shareholder interventions*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER AND ACTIVISM, 232 (Jennifer G. Hill & Randall S. Thomas eds. 2015) (noting that "[Some shareholder interventions] are motivated by an activist's belief that he or she has better ideas about how to run the company than the incumbents, which may be true sometimes but often seems dubious.")
[348] Yaron Nili, Servants of Two Masters? The Feigned Hysteria over Activist-Paid Directors, 18 U. PENN. J. BUS. L. 509, 540 (2016).
[349] Coffee, Jackson, Mitts & Bishop, *supra* note 320, at 391.

Hypothesis 7 – Activist hedge funds are more likely to appoint non-affiliated directors, rather than affiliated directors.

G. Activist Settlements

Research Question 8 – Are most activist directors appointed through negotiated settlement agreements or through proxy contests?

Hypothesis 8 – Activist board representation is more likely to be secured through settlement agreements rather than proxy contests.

Another research question that will be explored in my empirical study is whether activist board representation is most commonly secured through a proxy contest or through a settlement agreement negotiated between the activist hedge fund and the target company. Here, the hypothesis is that board representation is more likely to be secured through settlement agreements, rather than the campaign for board representation proceeding to a proxy contest and full shareholder vote. The upward trend in activist settlements was indeed reported in a recent paper by Bebchuk, Brav, Jiang and Keusch. Here, they conducted a study of activist settlement agreements between 2000 and 2015 and found that "[w]hile such settlements used to be rare, they now occur with significant frequency."[350] Although their data applied to a broader range of companies and activists and did not focus specifically on activist board representation, it was expected that my data would also reflect this general trend and reveal a similar pattern. Specifically, the authors found that activists formally start a proxy contest in 12% of activist campaigns, with only 38% of those cases then proceeding to a full shareholder vote.[351] Similarly, relying on studies by Lazard, Coffee, Jackson, Mitts and Bishop have noted that "the vast majority of the directors placed on the board as a result of activist pressure is appointed through privately negotiated settlements, thus allowing management to avoid the risk of a proxy contest."[352] The Lazard data showed that after 2014, the proportion of board seats

[350] Bebchuk, Brav, Jiang & Keusch, *Dancing with Activists*, *supra* note 302, at 2.
[351] Bebchuk, Brav, Jiang & Keusch, *Dancing with Activists*, *supra* note 302, at 6.
[352] Coffee, Jackson, Mitts & Bishop, *supra* note 320, at 388 (citing LAZARD SHAREHOLDER ADVISORY GROUP, REVIEW OF SHAREHOLDER ACTIVISM – Q1 2018, 5, https://www.lazard.com/media/450557/lazard-1q-2018-activism-review.pdf) [hereinafter LAZARD (2018)].

won via settlements rather than proxy contests increased considerably from 15% in 2014 to 27% in 2015, 35% in 2016 and 41% in 2017.[353] In their own study of settlement agreements between 2000 and 2015, Coffee, Jackson, Mitts and Bishop reported that "[t]he period 2011-2015 saw a substantial increase in the number of settlements with activist investors, and the first public criticisms by diversified institutional investors of activist behavior."[354]

Settlement agreements are a less adversarial mechanism through which activist hedge funds can achieve their goals. The increased prevalence of negotiated settlements may therefore reflect a less adversarial and more collaborative approach to activism on the part of both the activists and the target companies. While a proxy contest is necessarily hostile, a settlement agreement can be seen as a collaborative or cooperative alternative.[355] Settlement agreements involve concessions by the activist and by the target company. Ordinarily, the activist will agree to a "standstill", refraining from pursuing further activist activities and sometimes also prohibiting the activist from acquiring additional stock.[356] In return, the target company will accede to some of the activist's demands, for example by agreeing to appoint candidates nominated by the activist fund to the target company board.[357]

More cynically, one could view settlements as incumbent managers following the path of least resistance and seeking to avoid adverse publicity or a defeat in a proxy contest or hoping to retain their executive positions if they appease hedge fund activists with board seats. Scholars have criticized this "backroom deal-making"[358] and stated that "[s]killed at spin control, management would rather settle than fight."[359] Long-term institutional investors have also criticized settlement agreements between activist hedge funds and corporate management, arguing that they can be disenfranchised through this process.[360]

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[353] LAZARD (2018), *supra* note 352, at 5. *See also* Jim Rossman, Lazard, *Lazard's 1Q 2018 Activism Review*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Apr. 20, 2018) https://corpgov.law.harvard.edu/2018/04/20/lazards-1q-2018-activism-review/.
[354] Coffee, Jackson, Mitts & Bishop, *supra* note 320, at 390-91.
[355] Bebchuk, Brav, Jiang & Keusch, *Dancing with Activists*, *supra* note 302, at 4.
[356] *Id*.
[357] The study found that settlement terms tended to focus on board composition. *See* Bebchuk, Brav, Jiang & Keusch, *Dancing with Activists*, *supra* note 302, at 12-17.
[358] Coffee, Jackson, Mitts & Bishop, *supra* note 320, at 389.
[359] Coffee, Jackson, Mitts & Bishop, *supra* note 320, at 395.
[360] Rakhi Kumar & Ron O'Hanley, State Street Global Advisors, *Protecting Long-Term Shareholder Interests in Activist Engagements*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 17, 2016),

Here, the short-term versus long-term argument usually comes into play, which also illustrates the significance of the concerns over activist hedge fund short-termism to other investors. Concerns of disenfranchisement were initially raised by global asset managers in 2016, most vocally by State Street Global Advisors. Their concerns were repeated again more recently, where they highlighted that "[i]n 2018, record highs in campaign activity and board seats gained were set with 247 campaigns initiated and 161 board seats gained by activists. Of these board seats gained, an increasing number are being conceded by companies through settlement agreements. Over a three-year period from 2016-2018, 84% of board seats gained by activists were conceded through settlement agreements; a 15% increase over the 2013-2015 period levels, where 73% of seats were conceded through settlement agreements."[361]

Large asset managers and other long-term investors continue to emphasize the importance of target boards engaging with them when an activist campaign is initiated.[362] One example is in BlackRock's Larry Fink's Letter to CEOs in 2018, where he urged companies to engage with long-term shareholders early and bring other critical stakeholders to the table when activists offer valuable ideas.[363]

Regardless of the underlying motives of target company management, or the opinions of institutional investors, it seems that activists are becoming increasingly successful at swiftly obtaining board representation through settlements with target companies. Companies sometimes emphasize that they are working cooperatively with activists and often reach agreements with activists during the early stages of intervention. One example is JANA Partners' agreement with Tiffany & Co to add three non-affiliated directors to

https://corpgov.law.harvard.edu/2016/10/17/protecting-the-interests-of-long-term-shareholders-in-activist-engagements/.

[361] State Street Global Advisors, *supra* note 303, at 1-2.

[362] Michael Flaherty, *Big Funds push back against activist investor settlements*, REUTERS (July 18, 2016) https://www.reuters.com/article/us-activist-investors-idUSKCN0ZY2DP.

[363] Letter from Larry Fink, Chairman and Chief Exec. Officer, BlackRock, to CEOs, reproduced in Larry Fink, *A Sense of Purpose,* HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 17, 2018) https://corpgov.law.harvard.edu/2018/01/17/a-sense-of-purpose/ [hereinafter 2018 Letter from Larry Fink] (stating "Where activists do offer valuable ideas – which is more often than some detractors suggest – we encourage companies to begin discussions early, to engage with shareholders like BlackRock, and to bring other critical stakeholders to the table. But when a company waits until a proxy proposal to engage or fails to express its long-term strategy in a compelling manner, we believe the opportunity for meaningful dialogue has often already been missed.")

the Tiffany board, which was announced before the market was even aware that the activist was a 5% shareholder.[364]

The addition of activist directors is a very common condition of settlement agreements. Bebchuk, Brav, Jiang and Keusch's study which considered activist settlement agreements from 2000 (because settlements were rare before 2000) to 2013, noted that almost 84% of settlements stipulate the addition of new directors.[365] More unusually, some companies have even gone so far as to invite activist intervention or activist directors. For example, General Electric's CEO Jeff Immelt invited activist Nelson Peltz of Trian Partners, which did not own shares in the company, to become involved in GE. Trian ultimately invested $2.5 billion, which was its biggest investment to date at the time, and an affiliated representative of Trian Partners joined the board.[366]

There are various reasons why target companies may choose to settle rather than allowing the activist campaign to proceed to a proxy contest and shareholder vote. The first is cost and time. Proxy contests are expensive and consume a lot of management time. In the U.S., running a proxy contest for board representation can prove to be incredibly costly (both for the activist and the target company). Indeed, more than ten years ago the average cost of a proxy fight in the U.S. was believed to be in excess of $10 million.[367] Trian's proxy contest at Proctor & Gamble was reported as the most expensive in history, costing Trian $25 million, with P&G reportedly spending anywhere between $35 million and $100 million on its defense.[368] Another motivation for target company managers and directors to settle with an activist may be to try to preserve their own positions by

[364] Michael Flaherty, *Tiffany adds three directors in pact with activist JANA*, REUTERS (Feb. 21, 2017) https://www.reuters.com/article/us-tiffany-jana-idUSKBN1601AC (noting that "[t]he deal with JANA jolted the company's stock and came before the market was even aware the hedge fund was a shareholder.")
[365] Bebchuk, Brav, Jiang & Keusch, *Dancing with Activists*, *supra* note 302, at 4, 14.
[366] David Benoit, *Activism's Long Road From Corporate Raiding to Banner Year: Change in tactics let industry move beyond controversial past*, WALL ST. J. (Dec. 26, 2015) https://www.wsj.com/articles/activisms-long-road-from-corporate-raiding-to-banner-year-1451070910. Trian later invested $3.5 billion in P&G.
[367] Nickolay Gantchev, *The costs of shareholder activism: Evidence from a sequential decision model*, 107 J. FIN. ECON. 610, 611 (2012) (noting that "[a] campaign ending in a proxy fight has average costs of $10.71 million").
[368] Adam Hartung, *The Case for Trian's Nelson Peltz Joining P&G's Board*, *Forbes* (Sept. 7, 2017) https://www.forbes.com/sites/adamhartung/2017/09/07/the-case-for-trians-peltz-joining-the-pg-board/?sh=5f230cc839bb. *See also infra* Chapter 6, Section II. B. outlining the cost of Engine No. 1's proxy contest at ExxonMobil.

appeasing the activist. Coffee, Jackson, Mitts and Bishop argue that "the CEO's job is imperiled, unless he or she settles."[369]

[369] Coffee, Jackson, Mitts & Bishop, *supra* note 320, at 388. The CEO's job may also be imperiled even if they do settle. See *supra* Section E.

Chapter 4 – Activist Board Representation: An Empirical Study

I. SAMPLE CONSTRUCTION AND DATA DESCRIPTION

A. Hedge Fund Activism at S&P 500 Companies

For my analysis, I study activist hedge fund campaigns at S&P 500 companies in the period from 2010 to 2019. Launched in 1957, the S&P 500 was the first U.S. market-cap-weighted stock market index.[370] It is comprised of 500 large-cap companies.[371] Although S&P 500 companies make up approximately 14% of the total number of public companies in the U.S.,[372] they represent over 80% of the total market capitalization of the entire U.S stock market.[373] Therefore, the most economically significant companies are constituents of the S&P 500 index.

Constituent selection is at the discretion of the index committee and is based on eligibility criteria. The committee assesses the company's merit using criteria including company type (a primary listing on eligible U.S. exchanges), market capitalization (currently U.S. $11.8 billion or more), liquidity, financial viability, sector representation and length of time publicly traded (at least 12 months).[374] The median market capitalization of a public company in the U.S. is $1.6 billion (mean $13.5 billion, whereas the median market capitalization of an S&P 500 company is $29.9 billion (mean $72.8 billion).[375]

The decision to focus exclusively on S&P 500 companies[376] is a departure from the prior empirical literature on hedge fund activism, which has generally analyzed activism at a wider range of U.S. public companies. For example, several empirical papers on hedge fund activism, which introduced activist datasets in the late 2000s and early 2010s,

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[370] S&P DOW JONES INDICES, S&P 500 FACTSHEET, 1 (July 29, 2022), https://www.spglobal.com/spdji/en/indices/equity/sp-500/ [hereinafter S&P 500 FACTSHEET].
[371] S&P 500 FACTSHEET, *supra* note 370, at 1.
[372] There are 3,544 listed companies in the U.S. with readily available price data. *See* FT WILSHIRE 5000 TOTAL MARKET INDEX FACTSHEET, 1 (June 30, 2021), https://assets-global.website-files.com/60f8038183eb84c40e8c14e9/6132007be5f0a49e7a5f652a_ft-wilshire-5000-fact-sheet.pdf [hereinafter WILSHIRE 5000 FACTSHEET]. Reference is often also made to the Russell 3000 index, which represents approximately 96% of the investable U.S. equity market. *See* RUSSELL 3000 INDEX FACTSHEET, 1 (July 31, 2022) https://www.ftserussell.com/analytics/factsheets/home/search.
[373] S&P 500 FACTSHEET, *supra* note 370, at 1.
[374] Id.
[375] *Id.* and WILSHIRE 5000 FACTSHEET, *supra* note 372, at 1.
[376] *See infra* Section A. 2. for a discussion on the rationale behind focusing on the S&P 500.

considered U.S. public companies more broadly.[377] I will now review the scope of these datasets.

1. Prior Hedge Fund Activism Datasets

First, a dataset created by Brav, Jiang, Partnoy and Thomas was compiled by purchasing a list of Schedule 13D filings made by activist hedge funds at U.S. public companies between 2001 and 2006.[378] This generated a sample of 1,059 activist events (548 actively/publicly pursued campaigns and 511 more passive/private campaigns) at 882 unique target companies.[379] The Brav, Jiang, Partnoy and Thomas dataset has been further extended and analyzed in subsequent papers, for example in a law review article by Bebchuk, Brav and Jiang, an extended version of the dataset covering campaigns from 1994 to 2007 was referred to.[380] An updated version of the dataset (involving 4,657 hedge fund activist events spanning the time period 1994 through 2018) is also referenced in a 2022 working paper by Brav, Jiang and Li.[381]

Second, a dataset created by Clifford similarly utilized Schedule 13D filings and yielded a sample of 788 activist events between 1998 and 2005.[382] Third, a dataset created by Klein and Zur examined Schedule 13D and 13D/A filings of 151 activist events between 2003 and 2005.[383] Here, the sample was considerably smaller due to the three-year date range and because the dataset was restricted only to instances where activist hedge funds had filed Schedule 13Ds and cases where they had actively and publicly pursued campaigns.[384] Fourth, a dataset created by Bratton utilized press releases to create a sample of activist

[377] *See* Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277; Clifford, *supra* note 277; Klein & Zur, *supra* note 277; Bratton, *supra* note 272; Greenwood & Schor, *supra* note 277; Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681 (2007); and Boyson & Mooradian, *supra* note 332.

[378] Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1737-1739 (noting that the authors purchased a list of all Schedule 13D filers during the period 2001 to 2006 from LiveEdgar then manually filtered out the non-hedge fund filers).

[379] Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1739, 1741-1742. The final sample in this dataset comprised 1,059 hedge fund-target pairs at 882 unique target companies. However, this sample included 511 events where there was no active campaign to achieve specific goals (*see* p1741), leaving 548 active campaigns at an unspecified number of target companies.

[380] *See* Bebchuk, Brav & Jiang, *supra* note 228. The dataset was also used in other papers, for example Alon Brav, Wei Jiang, Song Ma & Xuan Tian, *supra* note 272 and Bebchuk, Brav, Jiang & Keusch, *Dancing with Activists*, *supra* note 302.

[381] *See* Brav, Jiang & Li, *Governance by Persuasion*, *supra* note 310.

[382] Clifford, *supra* note 377, at 326.

[383] Klein & Zur, *supra* note 277, at 187.

[384] Klein & Zur, *supra* note 277, at 195.

events at 130 firms from 1 January 2002 to 30 June 2006.[385] Fifth, Greenwood and Schor construct a dataset of activist filings with the SEC (Schedule 13D and DFAN14A filings)[386] from 1993 to 2006, consisting of 784 activist events initiated by 139 hedge funds.[387] Events were defined as instances in which an activist files a 13D filing announcing a 5% ownership and an intention to influence the management of the company.[388] Sixth, a study by Briggs compiled hand-gathered SEC filings for activist campaigns taking place in 2005 and the first eight months of 2006.[389] This resulted in a sample of 52 activist targets.[390] Finally, Boyson and Mooradian's sample covered 13D filings in the period 1994 to 2005 and included 418 activist events involving 111 hedge funds and 397 target firms.[391]

The datasets used in the prior empirical studies on hedge fund activism are summarized in the table below:

Table 1 – Prior Empirical Studies of Hedge Fund Activism

This table shows the sample years, total activist events and total target companies in the samples studied in the most often cited prior empirical studies of hedge fund activism.

Paper	Sample Years	Total Activist Events	Total Target Companies
Brav, Jiang, Partnoy & Thomas (2008)	2001 – 2006	548	
Clifford (2008)	1998 – 2005	788	
Klein & Zur (2009)	2003 – 2005	151	
Bratton (2007)	2002 – mid-2006	130	130
Greenwood & Schor (2009)	Q3 1993 – Q3 2006	784	
Briggs (2007)	2005 – mid-2006		52
Boyson & Mooradian (2011)	1994 – 2005	418	397

[385] Bratton, *supra* note 272, at 1385.
[386] DFAN14As are filed with the SEC by investors who intend to or are engaged in a proxy fight with a firm's management.
[387] Greenwood & Schor, *supra* note 277, at 364.
[388] *Id*, at 365.
[389] Briggs, *supra* note 377, at 695.
[390] *Id*, at 696.
[391] Boyson & Mooradian, *supra* note 332, at 170.

2. Focus on the S&P 500

There were various rationales for my decision to focus on S&P 500 companies and to depart from the data collection methods in prior literature. With respect to the focus on S&P 500 companies, prior literature has found that hedge fund activists tend to target smaller companies. For example, Bratton noted that "hedge funds concentrate their attention on the small capitalization sector"[392] and Brav, Jiang, Partnoy and Thomas found in their widely cited empirical study that "hedge funds are less likely to target larger firms because the fund would need to invest a large amount of capital in order to amass a meaningful stake."[393] Reliance on these empirical studies from the 2000s has led to a general perception that hedge fund activism continues to primarily focus on smaller companies to the present day. This can sometimes also be used as an argument to downplay the impact of hedge fund activism. For example, Brian Cheffins states in his 2018 book, *The Public Company Transformed*, that "Gilson and Gordon likely overestimate the clout of activist hedge funds which is significant but has been compromised from a governance perspective by the continued bias in favor of targeting smaller companies as well as by the episodic nature of hedge fund interventions."[394] However, since the empirical studies documenting activism in the 2000s, activist hedge fund behavior has changed considerably. As my empirical study shows, over the past decade at least, the largest and most prominent activist hedge funds have increasingly targeted some of the biggest companies in the United States.

This relatively recent development of activists targeting S&P 500 companies is not systematically documented or explored in the literature. This thesis fills a gap in the literature by analyzing hedge fund activism at S&P 500 companies. It is undoubtedly true, as Martin Lipton states, that "no company should consider itself immune from activism. No company is too large, too new, or too successful."[395] The empirical data presented here

[392] Bratton, *supra* note 272, at 1387.
[393] Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1752.
[394] CHEFFINS, *supra* note 7, at 372 (Cheffins does also note that "Caveats aside, hedge fund activism has been a meaningful shareholder value catalyst and likely will remain so for the foreseeable future").
[395] Martin Lipton, *Dealing with Activist Hedge Funds and Other Activist Investors*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sep. 2, 2022) https://corpgov.law.harvard.edu/2022/09/02/dealing-with-activist-hedge-funds-and-other-activist-investors-5/; Martin Lipton, *Dealing with Activist Hedge Funds and Other Activist Investors*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 6, 2021) https://corpgov.law.harvard.edu/2021/10/06/dealing-with-activist-hedge-funds-and-other-activist-investors-4/.

on recent activist campaigns at S&P 500 companies can also help to avoid caveats that were necessary in very recent academic scholarship. For example, in Coffee and Palia's survey of the empirical evidence in 2016, it was necessary to caveat that "all of these studies end generally no later than hedge fund interventions initiated in 2007. Since that time, hedge fund activism has accelerated substantially and altered its targets, thus having impacts that these studies may not capture."[396] Many normative or policy-oriented papers discussing hedge fund activism still use empirical evidence and datasets that do not necessarily reflect the more recent evolution of activist hedge fund behavior. This data is commonly used to support policy arguments about hedge fund activism. However, a reliance on studies that primarily focus on smaller companies and that analyze hedge fund behavior prior to more recent changes in such behavior may be of limited usefulness and could even result in a misrepresentation of current activist hedge fund behavior. As illustrated in Chapter 2, the narrative on activist short-termism is strong. Therefore, it is important to have a clear picture of the current activities of activist hedge funds at the most economically significant companies in order to assess whether accusations of short-termism are well founded or not. Yet the data that is most commonly cited to support policy arguments about hedge fund activism does not focus on activism at the largest U.S. companies, nor does it reflect important developments that have taken place with respect to activist hedge fund behavior since the early empirical studies were published.

In addition to documenting recent trends of activists targeting large companies, compiling a dataset of activist campaigns at S&P 500 companies enables a focus on the most economically significant companies and the most prolific, high-profile activist hedge funds in the United States. These companies and activists are the most likely actors to have an outsized (positive or negative) impact on stakeholders and society more generally. As noted above, the S&P 500 is significant as these companies represent over 80% of the total market capitalization of the U.S. stock market. It also follows that activism at such companies would similarly have an outsized impact on the economy at large. As one example of the stakeholder impact, S&P 500 companies employ approximately 70% of the overall workforce of Russell 3000 companies.[397] Further, on a global scale, large U.S.

[396] Coffee & Palia, *supra* note 6, at 54.

[397] *See* Strine, *Who Bleeds*, *supra* note 1, at 1886 (citing Justin Fox, *Big Companies Still Employ Lots of People*, BLOOMBERG (Apr. 20, 2016), https://www.bloomberg.com/view/articles/2016-04-20/big-companies-still-employ-lots-of-people) (also noting that "however attractive it is for politicians to talk about small business

companies tend also to have an outsized role in the global economy. In 2022, five of the top ten largest companies in the world by revenue were U.S. companies, and 37 of the top 100 companies by revenue were American.[398] For publicly traded companies ranked by market capitalization, 63 of the largest 100 companies were U.S. companies.[399]

As S&P 500 companies are likely to have the biggest impact on stakeholders and the global economy, it is useful to study activist campaigns at these firms separately. Activism at small cap companies can be quite different to activism at large cap companies. The players involved also often tend to be different. For example, my data shows that there is only a small group of very large activist hedge funds that target S&P 500 companies.[400] On the other hand, a much broader range of activist hedge funds target smaller companies.[401] To avoid averaging out results that then present a distorted picture of what actually happens at the largest companies, it is helpful to study the biggest companies in the United States separately to obtain a clear picture of what form hedge fund activism takes at these important companies.

Despite the wider general remit of earlier papers, one key paper did separately mention the importance of activism at major companies and by high-profile activist hedge funds. Here, Bebchuk, Brav, Jiang and Keusch included tables of activist campaign data at "notable targets" (defined as firms with a market capitalization of $7 billion and above) and by "notable activists" (defined as activists with four or more interventions between 2000 and 2013).[402] This data more closely resembles the activists and target companies in

being the engine for job growth, the reality remains that public companies are the most vital source of jobs in our economy").

[398] Forbes, *The World's Biggest Companies – 2022 Ranking*, https://www.forbes.com/sites/forbesstaff/2022/05/12/forbes-global-2000-list-2022-the-top-200/?sh=465d096b3290, *see* CHEFFINS, *supra* note 7, at 10.

[399] PWC, *Global Top 100 Companies – March 2022*, https://www.pwc.com/gx/en/services/audit-assurance/publications/global-top-100-companies.html, *see* CHEFFINS, *supra* note 7, at 357.

[400] *See infra* Chapter 4, Section II. A. 1. (showing that only thirteen activist hedge funds initiated more than one board representation campaign at an S&P 500 company in the ten years from 2010 to 2019 and that six activist hedge funds were responsible for more than two-thirds of all activist board representation campaigns at S&P 500 companies).

[401] For example, there were 197 distinct activist hedge funds in the Clifford study (Clifford, *supra* note 277, at 326), 139 distinct activist hedge funds in the Greenwood & Schor study (Greenwood & Schor, *supra* note 277, at 364), and 111 distinct hedge funds in the Boyson & Mooradian study (*see* Boyson & Mooradian, *supra* note 332, at 175).

[402] Bebchuk, Brav, Jiang & Keusch, *Dancing with Activists*, *supra* note 302, at 6, 35, 36.

my study, although there is only an overlap of three years between the authors' sample period and my sample period.

Regarding the data collection methods, had I precisely followed the data collection methodologies in the prior foundational literature – where the datasets were compiled by purchasing lists of Schedule 13D filings – this would have resulted in a significant number of high-profile modern day activist hedge fund campaigns at S&P 500 companies not being captured in the initial data gathering process. In the 2000s, this methodology made sense as the logical starting point because activist hedge fund campaigns at large cap companies were very rare. However, in the past decade activist hedge funds have increasingly targeted higher profile economically significant large-cap S&P 500 companies. The larger market capitalization of these companies results in the activists generally holding a lower percentage of the target company shares, compared to the percentage held at small or mid-cap companies – often below the 5% level which triggers the requirement to file a Schedule 13D.[403] Therefore, an alternative starting point for data collection was necessary for my study to ensure that those important cases would be appropriately captured.

B. Data Collection

My study analyzes activist hedge fund events in a ten-year period from 1 January 2010 until 31 December 2019. Given the hypothesis and anecdotal evidence that activist hedge fund strategies have evolved considerably in recent years, the date range of 2010 to 2019 was chosen to reflect the most recent activist campaigns and the most relevant, up-to-date, activist hedge fund strategies. This is an important contribution to the literature by virtue of the recent nature of the campaigns alone, as it is the most up-to-date study of the constantly evolving phenomenon of hedge fund activism.[404] Moreover, my study is the

[403] In Brav, Jiang, Partnoy & Thomas' sample, it was noted that "relatively few targeted companies are large-cap firms, which is not surprising given the comparatively high cost of amassing a meaningful stake in such a target". *See* Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1730. The Klein & Zur study and the Greenwood & Schor study also omit activism below the 5% reporting threshold. *See* Klein & Zur, *supra* note 277, at 195 and Greenwood & Schor, *supra* note 277, at 364.

[404] The most up-to-date empirical studies on hedge fund activism tend to study data up to the first half of the 2010s. For example, Krishnan, Partnoy and Thomas use a large dataset of hand-collected information on activist interventions from January 1, 2008 to May 1, 2014. *See* C.N.V. Krishnan, Frank Partnoy & Randall S. Thomas, *The second wave of hedge fund activism: The importance of reputation, clout, and experience*, 40 J. CORP. FIN. 296 (2016). Other recently published studies, such as the comprehensive study of worldwide hedge fund activism by Becht, Franks, Grant and Wanger, consider campaigns in the previous decade. *See* Marco Becht, Julian Franks, Jeremy Grant & Hannes Wagner, *The Returns to Hedge Fund Activism: An International Study*,

first to provide an in-depth comparison of activist board-representation campaigns with non-board-level campaigns. In this respect, it was desirable to focus on the most up-to-date campaigns as board-level activist campaigns were rare at S&P 500 companies prior to 2010.[405] Although data was also available for 2020 and 2021, I decided on a cut-off of 31 December 2019 for the activist intervention to have begun. One reason for this was that one of the variables to be studied was the duration of the activist investment. This of course cannot be examined by analyzing campaigns that have only recently begun and have not been exited yet. To provide the fullest data for investment duration, activist hedge fund exits were recorded up to 30 June 2022.

1. List of S&P 500 Companies

As the S&P 500 index is regularly reconstituted, the first step of the data collection process involved constructing a comprehensive list of all companies that were constituents of the S&P 500 during the sample period. This involved manually compiling a list of companies that were constituents of the S&P 500 at some point during 2010 to 2019 using publicly available sources that identified the date each specific company was added to or removed from the S&P 500 index.[406] The original resource used for this purpose contained some duplicates (for example when companies had changed name) so the information was manually checked against other publicly available lists of S&P 500 companies and verified with google searches of each specific company. This exercise resulted in a final list of 700 unique S&P 500 constituent companies, which were recorded together with the date each company was added to or removed from the S&P 500 index.

2. Activist Campaigns

Once the list of S&P 500 constituent companies was complete, the second step was to conduct searches to determine whether there had been activist campaigns at these companies. In order to be included in the dataset, the activist campaign had to have taken place at a company that was in the S&P 500 at the time the activist campaign began. As noted above, the initial list of activist events was not compiled by purchasing lists of

30 REV. FIN. STUD. 2933 (2017) (analysing hedge fund activism in 23 countries during the period 2000-2010).

[405] *See infra* Section II. A. 2. Chart 4.

[406] ANALYZING ALPHA, THE S&P 500 HISTORICAL COMPONENTS & CHANGES, https://analyzingalpha.com/sp500-historical-components-and-changes.

Schedule 13D filings (as had been done in prior literature). Rather, I used a professional database of shareholder activism events – Activist Insight (Insightia)[407] – to generate a preliminary list of companies targeted by activist hedge funds. The sources of information used and cross-referenced in the Activist Insight database are wider than Schedule 13D filings as they include other SEC filings (for example Activists' 13F filings), press releases, news and trade publications, and company websites.

I therefore conducted a search in Activist Insight for all activist campaigns at U.S. companies. The results of this search were then cross-checked against the list of the 700 S&P 500 companies (compiled in step one above). This manual process resulted in a list of 501 matches where S&P 500 companies had been the target of some form of activist intervention. This list included all recorded types of activism by any type of shareholder activist.

To account for any errors in the Activist Insight database, I then conducted extensive Google and Factiva searches on the remaining 199 companies that were to be excluded from the sample, to uncover any activist hedge fund campaigns that may not have been identified by the Activist Insight database. This process identified three additional target companies[408] that had not been listed in the Activist Insight search, which were then added to the sample of 501 companies to give a total of 504 target companies. There was no opportunity to cross-check my dataset against any of the other datasets referred to in Section I.A.1. above, as my dataset contained campaigns from 2010 to 2019 and the previous empirical studies all analyzed activist campaigns up to 2005 or 2006. It was possible to cross-check some of my data (for the first three years from 2010 to 2013) against a more recent paper by Bebchuk, Brav, Jiang and Keusch on activist settlements, as this paper included data from 2000 to 2013.[409]

3. Activist Hedge Fund Campaigns

The third step in the sample construction process was to manually filter out the campaigns where the activist investor was not an activist hedge fund. There is no central database of

[407] Activist Insight, an Insightia company, https://www.activistinsight.com.
[408] JC Penney, Perrigo Company and Transocean.
[409] *See infra* Section II A 1. However, this article only contained details of settlements, and not, for example, unsuccessful proxy contests.

activist hedge funds[410] nor is there a universally agreed upon definition of a hedge fund.[411] Rather, it has been noted that the term "hedge funds" is "loosely defined".[412] Therefore, identifying activist hedge fund campaigns always involves some element of judgment in determining whether an activist investor is appropriately classified as a hedge fund.[413]

The SEC has described a hedge fund as any privately offered "entity that holds a pool of securities" or other assets and that is not a registered mutual fund.[414] A commonly agreed upon description of the defining properties of hedge funds that is often used in policy contexts in both the U.S. and the U.K. is "any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public."[415] Scholars in the field have highlighted that hedge funds are typically identified by four key characteristics: (1) they are pooled, privately organized investment vehicles; (2) they are administered by professional investment managers with performance-based compensation and significant investments in the fund; (3) they are not widely available to the public, but rather only to "accredited investors" who are institutional investors and high net worth individuals;[416] and (4) they operate largely

[410] Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1736.
[411] FINANCIAL SERVICES AUTHORITY, HEDGE FUNDS AND THE FSA, DISCUSSION PAPER 16, 8 (Aug. 2002) August 2002, 8, https://webarchive.nationalarchives.gov.uk/ukgwa/20130202110317mp_/http://www.fsa.gov.uk/pubs/discussion/dp16.pdf.
[412] Brav, Jiang & Li, *Governance by Persuasion*, *supra* note 310, at 9.
[413] *See* Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1736-1737 (noting that various steps were taken to decide whether activists should be classified as hedge funds including searching the internet for their websites and news articles describing them, and calling them to ask for their self-classification); Greenwood & Schor, *supra* note 277, at 364 (noting that the authors used company websites, newspaper articles and the Center for International Securities and Derivatives Markets (CISDM) hedge fund database to determine whether or not the activist was a hedge fund or another type of investor).
[414] *See* Briggs, *supra* note 377, at 686 (citing Div. of Inv. Mgmt and Office of Compliance Inspections & Examinations, SEC Staff Report, Implications of the Growth of Hedge Funds 3 (2003), http://www.sec.gov/news/studies/hedgefunds0903.pdf).
[415] *See* FINANCIAL SERVICES AUTHORITY, *supra* note 24, at 8 (citing U.S. *"President's Working Group on Financial Markets"*, 1999).
[416] In the United States, hedge funds raise capital from high-net-worth individuals and institutional investors using an exemption for "private offerings" under Rule 506 of Regulation D of the Securities Act of 1933. Such funds will only be open to "accredited investors," – institutional investors, insiders or individuals with a minimum net worth of $1 million or a minimum income of $200,000 in each of the last two years and a reasonable expectation of reaching the same income level in the current year. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the SEC was given authority to adjust the net worth and income standards for individuals as it deems appropriate.

outside of securities regulation and registration requirements that apply to investments marketed to retail investors.[417] [418]

Section 404 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 directed the SEC to establish reporting requirements for private funds, including hedge funds. This was done using Form PF reports for private funds. For the purposes of Form PF, a private investment fund will be classified as a hedge fund if it: (1) may be paid a performance fee calculated by taking into account unrealized gains; (2) may borrow in excess of one-half of its net asset value (or have gross notional exposure in excess of twice its net asset value); or (3) may sell securities short.[419]

Activist Insight does not have a search function to search by a particular type of activist.[420] Therefore, it was not possible to search for campaigns conducted only by activist hedge funds. Instead, I manually compiled a list of activists that had targeted each of the target companies. From the list of 504 target companies, 336 companies were easily identified as targets of activist hedge funds, as they involved campaigns by at least one major, well known, activist hedge fund.[421] Next, 85 of the 504 companies were clearly identified not to be targets of activist hedge funds. Instead, these companies were targeted by public

[417] Many investors in larger hedge funds must also meet heightened "qualified purchaser" standards under the Investment Company Act of 1940, which generally requires individuals to have $5 million in investments and requires companies and pension plans to have $25 million in investments. A hedge fund that exclusively accepts qualified purchasers as investors will qualify for a regulatory exemption under the Investment Company Act of 1940, which means the fund can gain access to an unlimited number of investors while maintaining maximum flexibility regarding its corporate structure and investing methodology.

[418] Frank Partnoy & Randall S. Thomas, *The New Shareholder Activism* (2005), https://ssrn.com/abstract=876344; Alon Brav, Wei Jiang, Frank Partnoy & Randall S. Thomas, *The Returns to Hedge Fund Activism*, 64 FINANCIAL ANALYSTS JOURNAL 45, 46 (2008) [hereinafter *Returns to Hedge Fund Activism*] Frank Partnoy, *US hedge fund activism*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER AND ACTIVISM, 101-102 (Jennifer G. Hill & Randall S. Thomas eds. 2015); Brav, Jiang & Li, *Governance by Persuasion*, *supra* note 310, at 9.

[419] U.S. Securities and Exchange Commission, Form PF, Glossary 4, https://www.sec/gov/files/formpf.pdf. *See also* Partnoy & Thomas, *supra* note 418, at 104. Form PFs submitted to the SEC are not publicly available.

[420] It is possible to search for campaigns initiated by particular activist hedge fund, e.g. Elliott Management, but it is not possible to search for all campaigns undertaken by activist hedge funds.

[421] These well-known activist hedge funds included Blue Harbour Group, Corvex Management, Elliott Management, Icahn Enterprises, JANA Partners, Marcato Capital Management, Pershing Square Capital Management, Relational Investors, Sachem Head Capital Management, Starboard Value, The Children's Investment Fund Management (TCI), Taconic Capital Advisors, Third Point Partners, Trian Fund Management and ValueAct Capital Partners.

pension funds,[422] labor unions,[423] individual "gadfly" investors,[424] other shareholder organizations,[425] family foundations[426] and religious organizations.[427] The activists targeting the remaining 83 companies were more ambiguous as they were less well known and so required further investigation and research to determine whether they would be appropriately classified as activist hedge funds. For these cases, I undertook a similar approach to that taken in previous literature by searching the internet for the websites of the funds to determine how they self-described and also by conducting general Google and Factiva searches for news articles describing the funds.[428]

At the conclusion of this process, 55 of the 83 remaining target companies were identified as the targets of at least one activist hedge fund and thus were retained in the sample, which now comprised 391 target companies overall.[429]

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[422] Such as the California Public Employees' Retirement System (CalPERS), the California State Teachers' Retirement System (CalSTRS) and the Office of the New York State Comptroller.
[423] Such as the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) and United Steelworkers.
[424] Such as John Chevedden, James McRitchie, Nick Rossi, Kenneth Steiner, William Steiner, Myra Young and Jing Zhao.
[425] Such as As You Sow, Majority Action, the Sierra Club and SumOfUs.
[426] Such as the Nathan Cummings Foundation.
[427] Such as Mercy Investment Services, Sisters of St. Francis of Philadelphia and Province of St. Joseph, Capuchin Order.
[428] A similar approach was taken in the Brav, Jiang, Partnoy & Thomas, Bratton, Clifford and Klein & Zur studies. *See* Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1737 (noting that the authors searched the internet for the websites of the filers and news articles describing them in order to classify them into hedge funds and nonhedged funds); Bratton, *supra* note 272, at 1386 (noting that some funds on the author's list of hedge funds might object to the "hedge fund" denomination e.g. Relational Investors, which operated solely as a long-term equity investor and ran no short positions); Clifford, *supra* note 377, at 326 (noting that the author confirmed that the activist in each filing was indeed a hedge fund through the fund's webpage, other web searches, or published media reports); and Klein & Zur, *supra* note 277, at 195 (noting that several sources were used to verify the classification including the funds' internet websites, investor journals, Factiva and newspaper and magazine articles to determine if the filer was recognised as being a hedge fund or other type of fund).
[429] Additional funds that were classified as activist hedge funds are as follows: Alken Asset Management, Altimeter Capital Management, Atlantic Investment Management, Barington Capital Group, BlueMountain Capital, Breeden Capital Management, Cadian Capital Management, D E Shaw Investment Management, Eminence Capital, Eton Park Capital Management, GAMCO Investors, HG Vora Capital Management, Hudson Executive Capital, Krupa Global Investors, Impactive Capital, Land and Buildings Investment Management, Paulson & Co, Perry Capital, PL Capital, P Schoenfeld Asset Management, Sandell Asset Management, SpringOwl Asset Management, Steel Partners and Stonerise Capital Management. There is some divergence in the literature regarding how GAMCO Investors (formerly known as Gabelli Asset Management) should be classified and whether its campaigns should be included in a dataset of activist hedge fund events. Kahan and Rock describe GAMCO as an activist hedge fund (*see* Kahan & Rock, *supra* note 255, at 1039). Klein and Zur include GAMCO in their non-hedge fund sample of "other entrepreneurial activists" (see Klein & Zur, *supra* note 277, at 195). Greenwood & Schor note that GAMCO is a "publicly traded investment management company that offers mutual funds to retail investors in addition to a number of investment advisory services and products to institutional and high-net worth individual investors, including hedge fund investments. Greenwood & Schor chose not to classify all of GAMCO's events as hedge fund events, as it is not clear whether the investment is being made either by and

4. Dates of Campaigns

Activist campaigns were only included in the sample if the campaigns began in the period from 1 January 2010 to 31 December 2019. Therefore, the fourth step in the process was to filter out any companies that were targeted either prior to 2010 or after 2019. Seven companies were identified as having been exclusively targeted before 2010, 32 companies were identified as exclusively targeted from 2020 onwards, and a further one company was targeted both before 2010 and after 2020 but not during 2010 to 2019.[430] Removing these 40 campaigns that fell outside of the designated date range resulted in an updated list of 351 target companies.

5. Actively Pursued Campaigns

The fifth step was to filter out the instances where the activist hedge fund campaigns were not actively pursued in public, namely when an activist held shares in the target company but there was no record of any active campaign. These activist holdings were included in the original sample as the Activist Insight database uses quarterly 13F filings of hedge funds as a data source, in addition to any 13D filings. Such cases could include instances where activist hedge funds passively held shares and never made the switch to an activist intervention during the relevant date range, or cases where no activism was publicly reported or disclosed as it consisted purely of private interactions with management.

To identify which campaigns in the sample were not actively pursued, I used the campaign information that is held in the Activist Insight database and supplemented this data with extensive internet and Factiva searches to determine whether there was any news coverage of the campaigns or any public campaign statements made by any of the activists involved.

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for its hedge fund, mutual fund, or other account. However, they include GAMCO events when the press release or 13D spells out activist demands (see Greenwood & Schor, *supra* note 277, at 364).
Funds that were not classified as activist hedge funds included Arjuna Capital (sustainable investor), Bluescape Energy Partners (private equity firm), Blum Capital (private equity firm), Cascade Investment (private holding company of Bill Gates), CtW Investment Group (labour activist group), Dana Investment Advisors (asset manager/investment advisor), Driehaus Capital Management (boutique investment advisor), Elevation Capital (private equity firm), Driehaus Capital Management (investment advisor), New Mountain Vantage Advisers (no outside investors), NorthStar Asset Management (sustainable wealth manager), Red Mountain Capital Partners (private equity firm), Sageview Capital (private equity firm), Southeastern Asset Management (employee owned, no outside investors).

[430] Note that these figures do not represent the total number of companies targeted pre-2010 and post-2019 because target companies were not removed from the sample if they were also targeted by a hedge fund from 2010-2019, in addition to being targeted either pre-2010 or post-2019.

At the conclusion of this process, 172 of the 351 target companies were identified not to be the targets of active or public campaigns. This proportion of active versus dormant campaigns (dormant campaigns representing 49% of the sample, or 172/351 target companies) is very similar to the findings of Brav, Jiang, Partnoy and Thomas, where 48.3% of their sample of activist events were instances where there was no public activism to achieve specific goals.[431] In 166 of these 172 cases, there was no 13D filing by the activist hedge fund. The activists also generally held quite small shareholdings in the company (typically less than 0.5%) and there was no record of any public statements or campaign strategy. In six cases, Schedule 13Ds had been filed yet there was no record of any active campaign during the relevant date range. Overall, these cases seem to be examples of options to engage in activism, rather than private campaigns, although it is not possible to determine this definitively. After removing these 172 companies, 179 target companies remained in the sample as examples of active campaigns pursued by hedge funds.

6. S&P 500 Index Reconstitution

As outlined in step one above, the date a company was added to or removed from the S&P 500 index was previously recorded. Activist campaigns were only included in the sample if they began while the company was a constituent of the S&P 500 index. Therefore, the sixth and final step in the data filtering process was to exclude any campaigns that took place either before or after a company was added to or removed from the S&P 500 index. Through this final filtering process, another 14 target companies were removed from the sample.

7. Final Sample

At the conclusion of the above six step procedure, there was a final sample of 165 S&P 500 companies that had been actively targeted by at least one activist hedge fund during the ten-year sample period. The actual number of hedge fund-target company pairs was larger than this, at 215 event pairs, as various companies were targeted by multiple activist hedge funds. Several companies were also targeted more than once by the same hedge fund, bringing the total number of actual activist events to 228. This final sample size was

[431] *See* Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1741-42. The authors included these campaigns in the total sample and events reported, even though it was not possible to conduct analysis on these campaigns due to their passive/private nature.

smaller than the samples used by Brav, Jiang, Partnoy and Thomas (548 active events), Clifford (788 events), Greenwood and Schor (784 events) and Boyson & Mooradian (418 events) but larger than the samples used by Klein and Zur (151 events), Bratton (130 activist-company pairs) and Briggs (52 target companies).[432]

II. DATA ANALYSIS

Following construction of the sample, data was gathered to test the hypotheses and answer the research questions set out in Chapter 3. Despite the fact that hedge funds fall outside of much regulation, there are two U.S. securities laws that require hedge funds to publicly disclose the holdings in their portfolios.

First, Section 13(d) of the Securities Exchange Act of 1934 requires that any investor, including a hedge fund, file a Schedule 13D with the U.S. Securities and Exchange Commission (SEC) within ten days of acquiring more than five percent of any class of securities of a publicly traded company if the investor has an interest in influencing the management of the company.

Second, Section 13(f) of the Securities Exchange Act of 1934 provides that institutional investors managing more than $100 million must file a Form 13F each quarter detailing the number of shares the investor holds in exchange-traded companies. Therefore, hedge funds with significant assets under management must make quarterly Form 13F filings to report their holdings.

As noted earlier, this study went beyond many of the previous studies as it included campaigns where no Schedule 13D was filed. Form 13F filings were particularly useful for this purpose, as Schedule 13D filings were not made for many of the activist campaigns in the sample. One of the major reasons for the lack of Schedule 13D filings is that a significant amount of capital is required to acquire a five percent stake in a large-cap S&P 500 company. In many of the sample events at the target companies, a Schedule 13D was not filed as hedge funds engaged in activism with less than a 5 percent stake. Overall, of

[432] Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1739, 1741-1742; Clifford, *supra* note 377, at 326; Klein & Zur, *supra* note 277, at 187; Bratton, *supra* note 272, at 1385-1386. Bratton's study was not limited to activist hedge funds, but rather focused on "hedge fund activists and other investment institutions that act like them".

the 228 activist events, there was a Schedule 13D filed in 99 activist campaigns (43.4% of the sample) and no Schedule 13D filed in 129 activist campaigns (56.6% of the sample).

This approach had the advantage of being more inclusive to capture more activist campaigns, and in particular to provide crucial data on the most recent campaigns and the evolution of hedge fund activism at S&P 500 companies. However, due to the variation in the information available in the different types of filings (Schedule 13Ds versus Form 13F filings), there was some imbalance in the dataset regarding the precision of information recorded for 13D and 13F events. This is mostly relevant to the investment horizon variable and is discussed further in that section below.

A. Prevalence of Activist Board Representation

1. Methodology

The next crucial stage of the process was to classify campaigns according to whether board representation was sought. Campaigns were classified as activist board representation campaigns where at least one of the strategies pursued by the activist hedge fund was to seek board representation. This included cases where the activist attempted to replace a subset of directors and cases where the activist aimed to take control of the board. The campaigns classified as non-board-level included all other activist events where board representation was not one of the publicly stated goals.

Data on the specific campaign strategies pursued by the activist hedge funds were gathered from a number of different sources including filings with the U.S. Securities Exchange Commission (SEC) (using the EDGAR filing database); the Activist Insight database; news reports gathered from Factiva searches; the activists' own websites and activist campaign websites; and general internet searches.

2. Results

In total there were 126 activist board representation campaigns at 101 unique companies and 102 non-board level campaigns at 85 unique companies. There was some overlap in the companies targeted: of the non-board level campaigns, 26 campaigns (at 21 unique

companies) took place at companies that were also the target of board representation by other activist hedge funds (either at the same time or at a different time).

As noted above, activist campaigns initiated up to the end of 2019 were included in the sample. Whether an activist board representation campaign fell within the sample period was determined using the date the 13D was filed or the media announcement date, as opposed to the date when board representation was sought or gained. Therefore, a couple of cases were included when 13Ds were filed before the end of 2019, but the board seats were not secured until 2020.[433]

Table 2 summarizes the total number of activist board representation campaigns and non-board level campaigns for each year of the study.

Table 2 – Activist Board Representation and Non-Board Level Campaigns at S&P 500 Companies (2010-2019)

This table shows the distribution of all activist board representation campaigns and non-board level campaigns that were launched at S&P 500 companies between calendar years 2010 and 2019. The relevant date used for the board representation campaigns is the date the board campaign was announced. The relevant date used for the non-board level campaigns is the date of the 13D or the media announcement.

Year	Activist Board Representation Campaigns	Percentage of Total Campaigns	Non-Board Level Campaigns	Percentage of Total Campaigns	Total Campaigns
2010	5	56%	4	44%	9
2011	8	73%	3	27%	11
2012	11	48%	12	52%	23
2013	11	41%	16	59%	27
2014	13	46%	15	54%	28
2015	23	58%	17	42%	40
2016	14	70%	6	30%	20
2017	16	70%	7	30%	23
2018	11	48%	12	52%	23
2019	12	55%	10	45%	22
2020	2				2
Total	126	55%	102	45%	228

To revisit the research questions and hypotheses presented in Chapter 3, Research Question 1 asked whether activist board representation is becoming a more common form

[433] These cases were LKQ Corporation where a 13D was filed on September 12, 2019 and board representation was granted on August 14, 2020 and Nielsen Holdings NV where a 13D was filed on August 13, 2018 and board representation was granted on April 30, 2020.

of hedge fund activism at S&P 500 companies and Hypothesis 1 was that activist board representation campaigns are increasingly prevalent at S&P 500 companies.

The below charts outline the number of activist board representation campaigns by year, the number of non-board level campaigns by year, and the percentage of each type of campaign per year.

Chart 1 – Number of Activist Board Representation Campaigns at S&P 500 Companies (2010 to 2019)

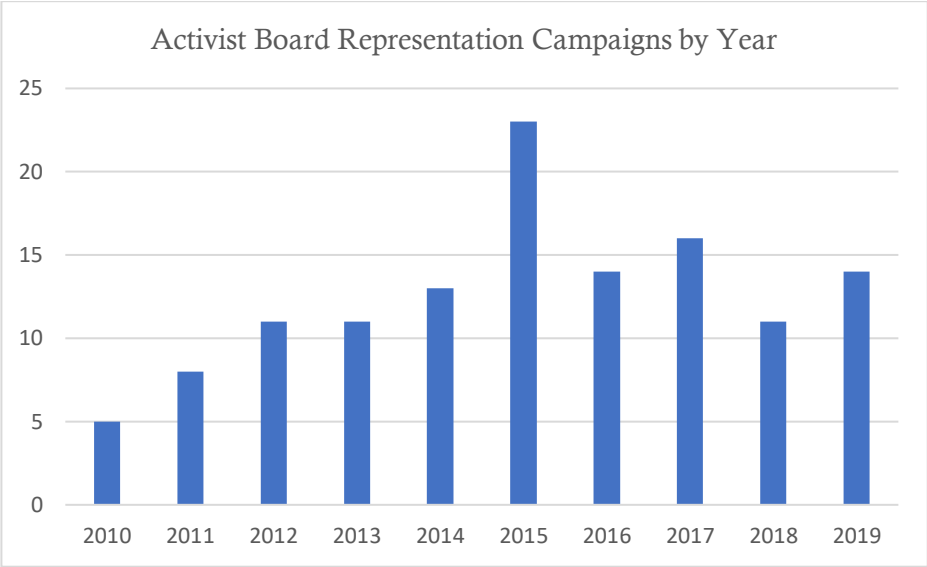


Chart 1 shows that in terms of the number of activist board representation campaigns, there is a steady increase from 2010 until 2015 when activist board representation campaigns peaked, followed by some slight decreases in 2016 to 2019 (although the number of campaigns still remain above 2010 to 2013 levels).

Chart 2 – Number of Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)

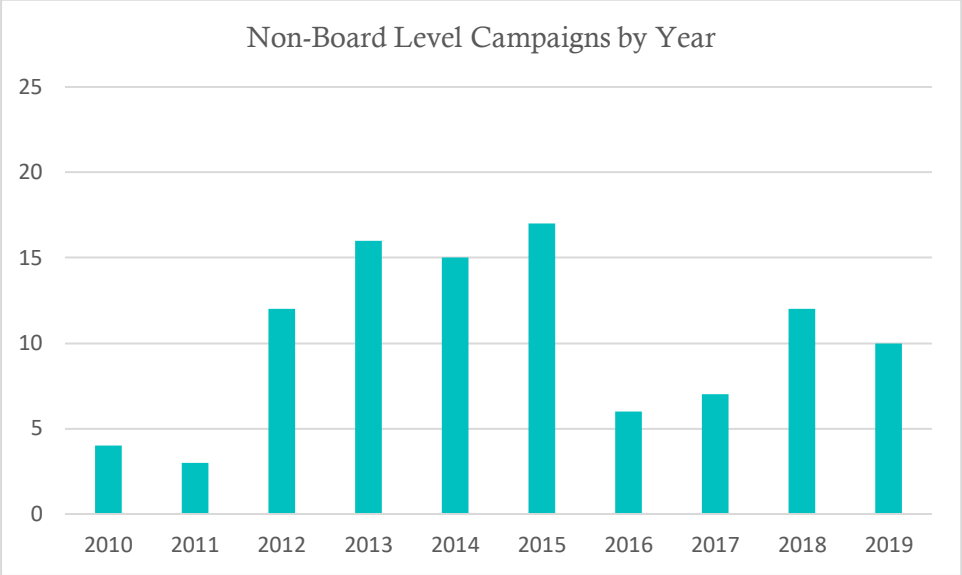
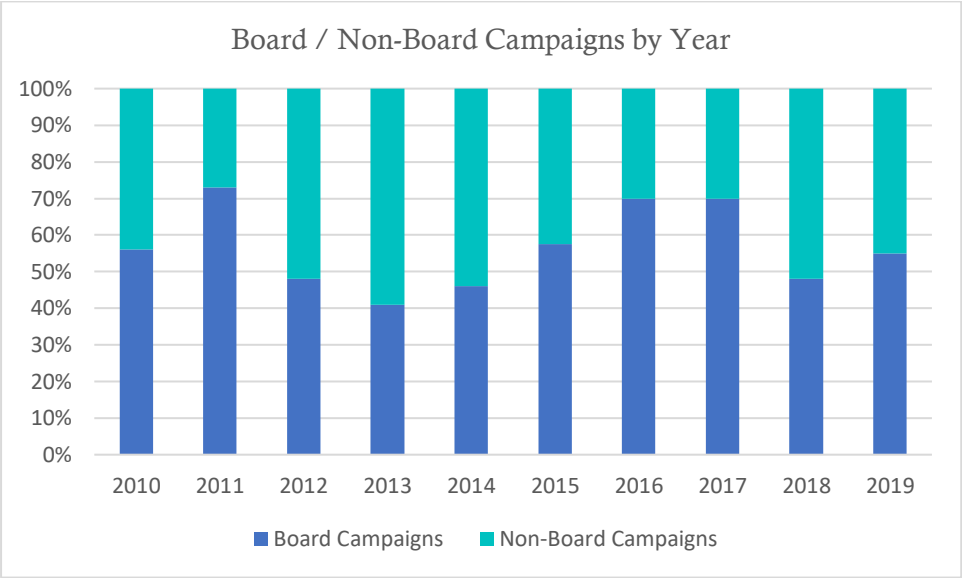


Chart 2 illustrates that the number of non-board level campaigns also decreased after 2015, so activist hedge fund campaigns peaked generally in 2015, before decreasing somewhat from 2016 to 2019.

Chart 3 – Percentage of Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)



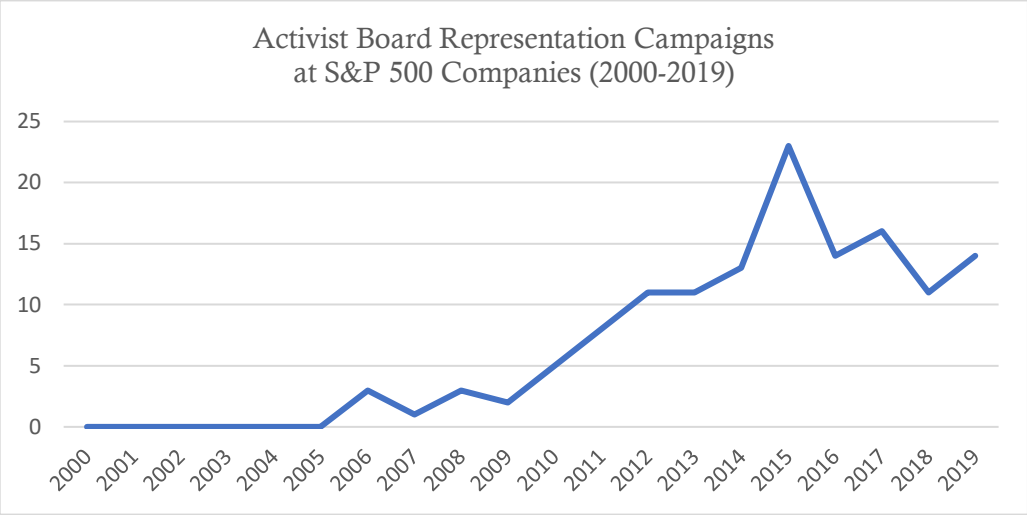
In terms of the percentage of total campaigns, Chart 3 shows that activist board representation campaigns were more common than non-board level campaigns from 2015 to 2017, before being more evenly split with non-board level campaigns in 2018 and 2019.

Overall, 55% of campaigns in the sample involved the activist hedge fund seeking board representation. In the first half of the decade (2010 to 2014), 49% of campaigns at S&P 500 companies involved requests for activist board representation and in the second half of the decade (2015 to 2019), 60% of activist campaigns at S&P 500 companies sought board representation.

I did not systematically analyze data prior to 2010, as my sample focused specifically on campaigns from 2010 to 2019. However, Chapter 3 Section II.A. above discussed the prevalence of activist board representation at S&P 500 companies prior to 2010. It was noted there – by combining results of two prior empirical studies – that there were only eight identified cases of activist board representation at S&P 500 companies from 2000 to 2009. There were some pre-2010 cases that I filtered out of my dataset during the steps identified in Section I.B.4. above. When I filtered out these pre-2010 campaigns, the cases I identified were consistent with those reported in the Bratton and Bebchuk studies, with the addition of one further target company/hedge fund pair that I identified. This was Pershing Square's unsuccessful proxy contest at Target Corporation in 2009. Therefore, it is estimated that there were only around nine campaigns for activist board representation at S&P 500 companies between 2000 and 2010.[434] This can be compared to 126 campaigns from 2010 to 2019. This is depicted in the chart below, to demonstrate the growth of activist board representation campaigns at S&P 500 companies in the past 20 years since 2000.

[434] This may not fully capture all of the activist board representation campaigns at S&P 500 companies between 2000 and 2009, since I did not specifically collect this data in a rigorous manner. However, it is believed to be a reasonable estimate relying on the findings of the prior studies referred to.

Chart 4 –Activist Board Representation Campaigns at S&P 500 Companies (2000 to 2010)



Research Question 2 that was presented in Chapter 3 concerned whether activist board representation is becoming a more successful form of hedge fund activism. Hypothesis 2 was that activist board representation campaigns are increasingly successful. Chapter 3 presented some evidence of the success of activist board representation campaigns in earlier years, although this was not systematically investigated in any of the studies. The prior studies also concerned a broader range of companies than the S&P 500. Conceptually, it may be easier for activist hedge funds to succeed at smaller companies compared to some of the largest and most powerful companies in the United States.

However, my study revealed very high success rates for activist board representation campaigns at S&P 500 companies from 2010 to 2019 (success being defined in terms of the activist hedge fund securing at least one board seat). Indeed, the campaigns were almost always at least partially successful. In only 16 out of the 126 activist board representation campaigns studied did the hedge fund fail to secure any board representation at all. In 110 activist board representation campaigns, the activists secured at least one board seat, which is an overall success rate of 87%. Therefore, it seems that not only is activist board representation a more prevalent strategy at S&P 500 companies, it is also a very successful strategy.

3. Board Campaigns by Hedge Fund

The reported success rates of these campaigns may also be a feature of the specific types of activist hedge funds that target S&P 500 companies. The data revealed that a limited number of activist hedge funds initiate activist board representation campaigns, whereas a wider group of activist hedge funds are involved in non-board level campaigns. Table 3 below details the number of activist board representation campaigns and non-board level campaigns by activist hedge fund.

Table 3 – Activist Board Representation and Non-Board Level Campaigns at S&P 500 Companies by Hedge Fund

This table shows the number of activist board representation campaigns and non-board level campaigns that were launched at S&P 500 companies between calendar years 2010 and 2019 by hedge fund. The hedge funds are ranked in order of the largest number of activist board representation campaigns that they initiated.

Activist Hedge Fund	Number of Board Representation Campaigns	Percentage of Total Board Campaigns	Number of Non-Board Level Campaigns	Percentage of Total Non-Board Level Campaigns
Icahn Enterprises	23	18.3%	6	5.9%
Elliott Management	21	16.7%	5	4.9%
Trian Fund Management	11	8.7%	2	2.0%
ValueAct Capital Partners	11	8.7%	5	4.9%
Starboard Value	10	7.9%	5	4.9%
JANA Partners	9	7.1%	11	11.0%
Pershing Square Capital Management	6	4.8%	5	4.9%
Corvex Management	5	4.0%	6	5.9%
Third Point Partners	4	3.2%	10	9.8%
Relational Investors	4	3.2%	6	5.9%
Land & Buildings	3	2.4%		
D E Shaw Investment Management	3	2.4%		
Sachem Head Capital Management	2	1.6%	2	2.0%
Other	14	11.1%	39	38.2%
Total	126		102	

Table 3 illustrates that only thirteen activist hedge funds initiated more than one board representation campaign at an S&P 500 company in the ten years from 2010 to 2019 and six activist hedge funds (Icahn Enterprises, Elliott Management, Trian Fund Management, ValueAct Capital Partners, Starboard Value and JANA Partners) were responsible for more than two-thirds (67.4%) of all activist board representation campaigns

at S&P 500 companies. Therefore, a very small group of formidable activist hedge funds are responsible for the majority of activist board representation campaigns at S&P 500 companies.

It is clear from this table that board representation has become the strategy of choice for a handful of activist hedge funds. Funds such as Icahn Enterprises, Elliott Management, Trian Fund Management, ValueAct Capital Partners and Starboard Value in particular initiate many more activist board representation campaigns at S&P 500 companies than they do non-board level campaigns. Funds such as JANA Partners, Pershing Square Capital Management and Corvex Management appear to take a more mixed approach to their campaign strategies as their campaigns are more evenly distributed between activist board representation and non-board level campaigns.

The activist hedge funds listed in Table 3 are also the largest such funds in the United States.[435] The evolution in the tactics used by these major activist hedge funds has largely driven the growth of activist board representation in S&P 500 companies since 2010.

B. Investment Horizon

1. Methodology

The investment duration of each activist hedge fund investment was estimated using multiple sources. The goal was to estimate as precisely as possible the date the activist hedge fund purchased shares in the target company and the date the activist hedge fund exited the target company. I identified the date the hedge fund purchased shares in each target company using four principal types of sources. If the activist holding was announced simultaneously with the filing of a Schedule 13D, the date of the Schedule 13D filing was used. Similarly, if the activist or the company made a media announcement regarding the activist holding, the specific date of purchase listed in the announcement was used. Extensive news searches were conducted in Factiva (using the activist hedge fund and

[435] The largest activist hedge funds in the U.S. (by assets under management in 2022) are: D E Shaw Investment Management ($60 billion); Elliott Management ($56 billion); Icahn Enterprises ($21 billion); Pershing Square Capital Management ($19 billion); Third Point Partners ($16 billion); ValueAct Capital ($16 billion); Trian Fund Management ($8 billion); Sachem Head Capital Management ($6 billion); Starboard Value ($5 billion); Corvex Management ($3 billion); and Jana Partners ($2 billion).

target company names as key words) and Google to gather this information. Additionally, if a proxy statement was filed, the specific date the activist bought shares in the company was extracted from the Schedule 13A form.

Brav, Jiang and Li recently noted that "a large majority of the hedge fund activism events begin, and are announced by, the filing of Schedule 13D with the U.S. Securities and Exchange Commission (SEC)" and that "Schedule 13D filings have been the primary information source for virtually all empirical studies of hedge fund activism in the U.S."[436] However, in my sample, there was a higher proportion of activist events that did not feature a Schedule 13D compared to events that did. Of the 228 activist events, there was a Schedule 13D filed in 99 events and no Schedule 13D filed in the remaining 129 events. The distribution of 13Ds compared to 13Fs was also not uniform between activist board representation and non-board level campaigns. In the sample, 74 out of the 126 activist board representation events (58.7%) involved a Schedule 13D filing, with the remaining 52 events relying upon information in 13F filings (41.3%). For the non-board level campaigns, only 25 events involved Schedule 13D filings (25%), with 77 events being based upon 13F data (75%).

For the campaigns where activist board representation was sought, a precise date when the activist hedge fund purchased shares in the target company could be identified (using one of the sources described above) for 73 out of 126 events (57.9%).[437]

For the remaining 53 events involving requests for activist board representation (42.1%), the best information available to estimate when the activist purchased the shares was quarterly 13F filings. Form 13F filings must be filed each quarter. Therefore, this information enabled me to identify in which specific quarter the activist bought the shares, although it was not possible to pinpoint the exact day of purchase. In these cases, the mid-point in the quarter was used as the date of purchase, as this represented the best estimate with the lowest overall error rate. To illustrate, if an activist hedge fund disclosed the holding on its 30 September 2018 13F filing, but not on its 30 June 2018 filing, the mid-point of 15 August 2018 was used as an estimated date of purchase. This date could

[436] Brav, Jiang & Li, *Governance by Persuasion*, *supra* note 310, at 12, 13.
[437] There were 13Ds in 74 out of 126 events (58.7%), but the 13D filing was not always done at the same time as the activist purchasing shares in the target company.

be incorrect by up to approximately 45 days. However, this was the best information available from SEC filings for these events.

For the non-board level campaigns, the same process was used. Here, a specific purchase date was identifiable in 43% of cases (44 out of 102 events), with the remaining 57% (58 out of 102 events) relying on 13F information.

To ascertain the date the activist hedge fund exited the investment, a similar process was followed. Given that using the mid-point ascertainable from 13F data could result in the purchase date being incorrect by up to 45 days and also the exit date being incorrect up to 45 days, some data on investment duration could theoretically be incorrect up to 90 days (3 months). However, this was the best information available for my study and for any previous empirical studies that report the investment duration of activist hedge fund campaigns. The same approach was used with regard to the activist board representation cases and the non-board level cases to ensure consistency.

In the study by Brav, Jiang, Partnoy and Thomas, the authors used multiple sources to determine the "exit date", including 13F data for the first quarter-end when the hedge fund's holding in the target company drops below 1%. These dates have the same error rates as was an issue for my study, and the authors acknowledge that the sources only allow them to form "estimates of the hedge fund's investment duration".[438]

2. Results

Research Question 3 asked whether activist board representation is associated with a longer-term investment approach on the part of the activist hedge fund. The hypothesis was that activist hedge funds that successfully secure board seats are likely to stay invested in target companies longer than activists without board seats.

The results of my study show that the average investment period of exited investments for campaigns where activists secured seats on the board is 3 years 1 month (3.06 years). The median is 2 years 11 months (2.87 years). However, this investment duration underestimates the average investment period of cases of activist board representation.

[438] Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1748-49.

Given the recent nature of the dataset, many of the investments where activists secured board representation have not been exited (22 out of 102 successful events, or 22%). Assuming an exit date of 30 June 2022 at a cutoff for the study, the average investment duration of investments that have not been exited would be 5 years and 9 months (5.71 years) and the median would also be 5 years and 9 months (5.72 years). If all those investments had in fact been exited on 30 June 2022, the overall average duration of activist board representation campaigns would increase to 3 years 8 months (3.63 years) overall. The median would increase to 3 years 4 months (3.30 years). These figures clearly underestimate the overall investment duration for the dataset of activist board representation campaigns, as 22% of campaigns are still ongoing, which will bring the overall average further upward. The complete picture of the overall average investment duration of the activist board representation campaigns in this sample will not be available for some years into the future but will clearly exceed 3 years and 8 months.

It should be noted that the above investment durations are for *successful* activist board representation campaigns. If the unsuccessful campaigns are also included, the average duration is slightly lower, at 2 years and 10 months (2.86 years) for exited campaigns (with a median of 2 years 9 months (2.75 years)) or an average of 3 years and 5 months (3.41 years) if ongoing campaigns (22 out of 114 events, or 19%) are included (with a median of 3 years 2 months (3.15 years). The difference between these two sets of averages can largely be explained by activist hedge funds exiting the investment after they failed to secure board representation or deciding to withdraw their campaign, as well as other intervening events such as the company being acquired.

By way of comparison, the average investment period of exited investments for non-board level campaigns is much shorter, at 19 months (1.61 years). The median is 15 months (1.25 years). Notably, these figures are more consistent with the findings in the Brav et al study regarding holding periods, where it was highlighted that "the median holding period for completed deals is about 1 year" and that an estimate for all events (including those not exited yet) is "closer to 20 months".[439]

[439] Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1731-1732.

These investment periods present a more accurate representation of the overall picture for non-board level activism as there are much fewer non-board level campaigns that have not been exited as of 30 June 2022 (6 of 96 events, or 7%) compared to the activist board representation events. If these ongoing events are included in the overall average investment duration (as of 30 June 2022), the average would only increase slightly to 21 months (1.79 years) (with a median of 15 months (1.27 years)).

Table 4 – Investment Periods for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010-2019)

This table shows the average and median investment periods for activist board representation and non-board level campaigns at S&P 500 companies, differentiating further between exited and current campaigns as well as successful board representation and all board representation campaigns. T-statistics and significance levels are reported for all comparisons of mean.

	Investment Period of Exited Campaigns	**Investment Period of Current Campaigns (at 30 June 2022)**	**Overall Investment Period (at 30 June 2022)**
Average Investment Periods (Standard Deviations)			
Successful Board Representation Campaigns	3.06 (1.55)	5.71 (2.18)	3.63 (2.02)
All Board Representation Campaigns	2.86 (1.57)	5.71 (2.13)	3.41 (2.05)
All Non-Board Level Campaigns	1.61 (1.38)	4.54 (1.35)	1.79 (1.55)
Median Investment Periods			
Successful Board Representation Campaigns	2.87	5.72	3.30
All Board Representation Campaigns	2.75	5.72	3.15
All Non-Board Level Campaigns	1.25	4.22	1.27

***T*-statistics for Comparison of Average Investment Periods**						
		Mean	S.D.	*n*	*t*	*df*
Investment Period of Exited Campaigns	Successful Board vs. All Non-Board	**3.06** **1.61**	1.55 1.38	80 90	6.42***	160
	All Board vs. All Non-Board	**2.86** **1.61**	1.57 1.38	92 90	5.69***	178
Investment Period of Ongoing Campaigns	Successful Board vs. All Non-Board	5.71 4.54	2.18 1.35	22 6	1.62	13
	All Board vs. All Non-Board	5.71 4.54	2.18 1.35	22 6	1.62	13

Overall Investment Period (Combined)	Successful Board vs. All Non-Board	**3.63** **1.79**	2.02 1.55	102 96	4.51***	217
	All Board vs. All Non-Board	**3.41** **1.79**	2.05 1.55	114 96	5.24***	220

S.D.: standard deviation, *n:* sample size, *t*: T-statistic, *df*: degrees of freedom, *, **, ***: statistically significant at $p<.05$, $p<.01$, and $p<.001$, respectively (one-tailed); means of significant differences are highlighted in bold font.

Regardless of the method of computation, it is estimated that, on average, the investment duration of activist board representation campaigns is between 78% and 103% longer than the duration of non-board level campaigns.

Comparison of means using a one-tailed heteroscedastic *t*-test showed that the average investment duration of activist board representation campaigns is significantly longer than the average investment duration of non-board level campaigns, both looking at the investment period of only exited campaigns and the investment period of all (exited and ongoing) campaigns combined. The results were consistent irrespective of whether I compare only successful activist board representation campaigns and all non-board level campaigns ($t(160) = 6.42$, $p < .001$, and $t(217) = 4.51$, $p < .001$, respectively) or all activist board representation campaigns and all non-board level campaigns ($t(178) = 5.69$, $p < .001$, and $t(220) = 5.24$, $p < .001$). The same significance levels were obtained when relaxing to a two-tailed t-test.

Previous studies have used the median investment duration of activist campaigns, rather than the average.[440] If using the median investment duration, the median board representation campaign is between 120% and 160% longer than the median non-board level campaign.

Charts 5 and 6 below depict the average and median investment periods for activist board representation campaigns and non-board level campaigns detailed above.

[440] *See, for example*, Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1731-32.

Chart 5 – Average Investment Period for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)

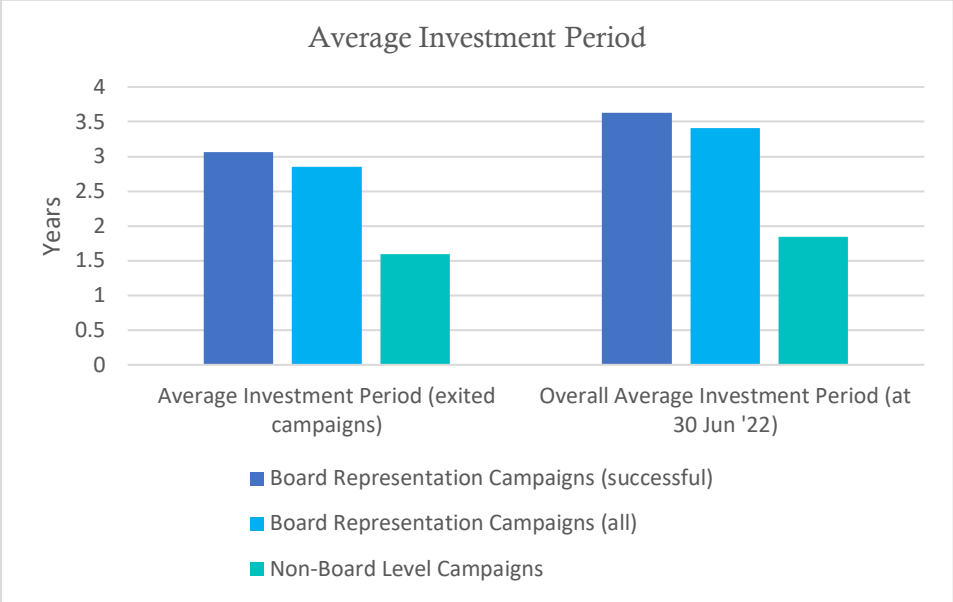


Chart 6 – Median Investment Period for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)

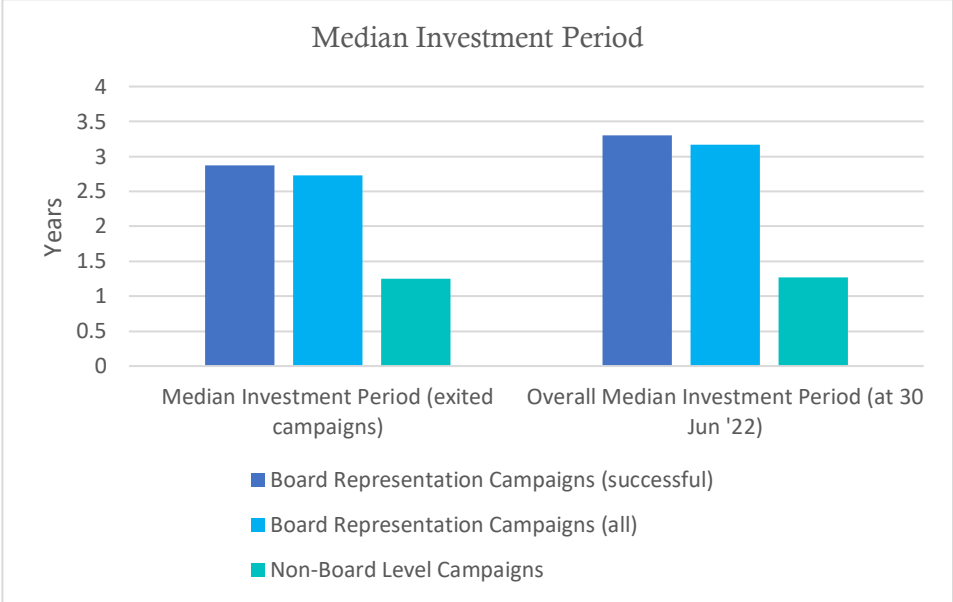
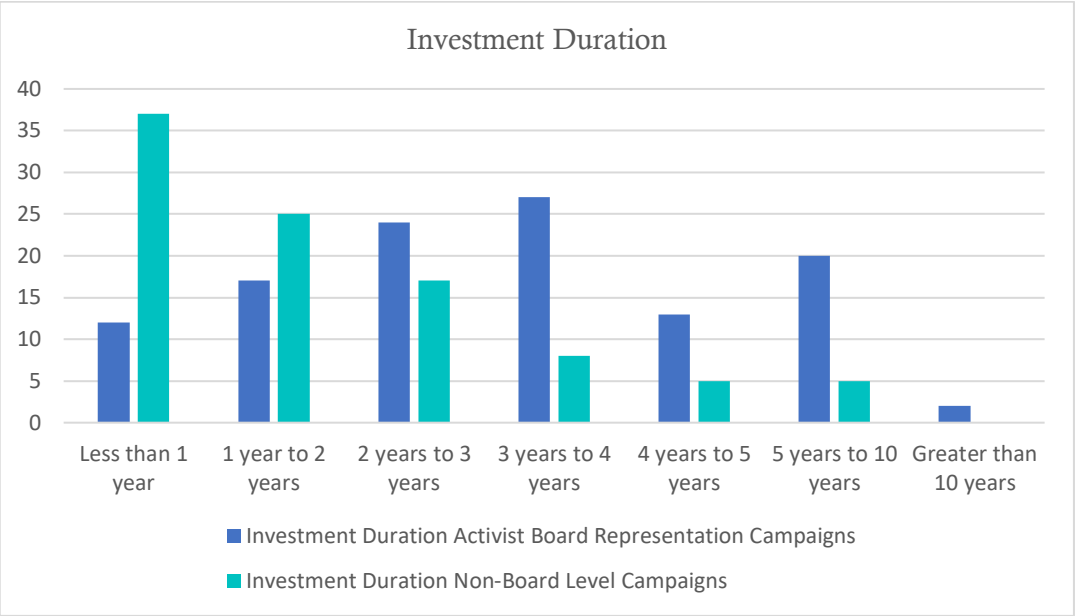


Chart 7 below shows the distribution of investment periods for activist board representation campaigns and non-board level campaigns. Here, we can see that most common investment period for non-board level campaigns is less than one year, and the most common investment period for activist board representation campaigns is between three and four years.

Chart 7 – Distribution of Investment Periods for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)



3. Longest Campaigns

While 3 years and 8 months is the average duration of successful activist board representation campaigns (assuming exits on 30 June 2022), there are numerous campaigns with investment periods significantly exceeding this average. In 22 campaigns at 20 companies (19% of the activist board representation events or 20% of the companies targeted), the hedge fund was (or has been) invested in the target company for a period of more than five years. Such investment periods represent a considerable deviation from the traditional description of activist hedge fund behavior. This can be seen from Chart 7 above, and the longest board representation campaigns in the sample are also outlined in Table 5 below.

Table 5 – Activist Board Representation Campaigns with Investment Periods Exceeding 5 years

Activist board representation campaigns initiated at S&P 500 companies between 2010 and 2019 where the activist hedge fund has been invested for a period of more than five years (data on exits collected up to 30 June 2022).

	Company	Year Board Seats Sought	Activist Hedge Fund	Investment Period (years) (at 30 Jun 2022)	Ongoing or Exited (at 30 Jun 2022)
1.	CBRE Group Inc	2012	ValueAct Capital Partners	10.52	Ongoing
2.	Mondelez International Inc (formerly Kraft Foods)	2014	Trian Fund Management	10.13	Ongoing
3.	Wells Fargo & Company	2016	GAMCO Investors	8.38	Ongoing
4.	General Electric Company	2017	Trian Fund Management	7.13	Ongoing
5.	Sysco Corporation	2015	Trian Fund Management	7.13	Ongoing
6.	Citrix Systems Inc	2015	Elliott Management	7.06	Ongoing
7.	Conagra Brands Inc	2015/2019	JANA Partners	7.04	Ongoing
8.	Hess Corporation	2013	Elliott Management	6.88	Exited
9.	United Airlines Holdings	2016	Altimeter Capital Management PAR Capital Management (joint)	6.43	Ongoing
10.	MGM Resorts International	2015	Land & Buildings	6.42	Exited
11.	Bank of New York Mellon Corporation	2014	Trian Fund Management	6.38	Exited
12.	The Williams Companies Inc	2013/2016	Soroban Capital Partners	6.26	Exited
13.	Arconic (now Howmet Aerospace Inc)	2016/2017	Elliott Management	6.23	Exited
14.	Chesapeake Energy Corporation	2012	Icahn Enterprises	6.17	Exited
15.	Seagate Technology	2018	ValueAct Capital Partners	6.13	Ongoing
16.	Chipotle Mexican Grill Inc	2016	Pershing Square Capital Management	5.82	Ongoing

17.	Procter & Gamble	2017	Trian Fund Management	5.62	Ongoing
18.	Dow Chemical Company	2014	Third Point Partners	5.57	Exited
19.	Advance Auto Parts Inc	2015	Starboard Value	5.39	Exited
20.	Baxter International Inc	2015	Third Point Partners	5.13	Exited
21.	Microsoft Corporation	2013	ValueAct Capital Partners	5.01	Exited

It is clear from this table that some activist hedge funds tend to focus on longer-term investments more than others, even within the activist board representation subsample. Most prominently, Trian Fund Management has been invested for more than 5 years in 50% (5 out of 10) of its activist board representation corporate targets. Trian clearly does not embody the typical critique of activist hedge funds as short-term investors, as the average tenure of its investments where the fund secured activist board representation from 2010 to 2019 is 5 years and 7 months (and rising, as four of the campaigns are ongoing).

Table 6 below outlines the duration of Trian's investments when it secured board representation.

Table 6 – Trian Fund Management Activist Campaigns

Activist board representation campaigns initiated at S&P 500 companies between 2010 and 2019 by Trian Fund Management (data on exits collected up to 30 June 2022).

	Company	Year Board Seats Sought	Activist Directors Appointed	Investment Period (years) (at 30 Jun 2022)	Current Shareholder or Exited (at 30 Jun 2022)
1.	Mondelez International Inc (formerly Kraft Foods)	2014	1 affiliated	10.13	Current
2.	General Electric Company	2017	1 affiliated	7.13	Current
3.	Sysco Corporation	2015	2 affiliated	7.13	Current
4.	Bank of New York Mellon Corporation	2014	1 affiliated	6.38	Exited (sold shares)
5.	Procter & Gamble	2017	1 affiliated	5.62	Current

6.	Family Dollar Stores Inc	2011	1 affiliated	4.94	Exited (acquired by Dollar Tree Inc)
7.	DuPont (E.I. du Pont de Nemours and Company)	2015	0 (unsuccessful proxy contest)	4.30	Exited (merged with Dow Chemicals)
8.	Pentair plc (2 campaigns)	2018	1 affiliated	3.63	Exited (sold shares)
9.	Trane Technologies (formerly Ingersoll Rand)	2012	1 affiliated	3.52	Exited (sold shares)
10.	PepsiCo Inc	2015	1 affiliated	3.25	Exited (sold shares)

It is also worth noting here that Trian Fund Management is also atypical of the activist hedge funds in the dataset as it exclusively put affiliated directors on the boards of target companies. In each case of a successful board representation campaign, the director appointed was a representative of Trian.[441]

4. Shortest Campaigns

On the other hand, there do remain some activist board representation campaigns with significantly shorter than average investment periods. Twelve activist campaigns (10% of the activist board representation events or 12% of the companies targeted) had an investment period of less than one year. The shortest campaigns in the sample are outlined in Table 7 below:

[441] At Mondelez, Nelson Peltz (Trian's CEO and a Founding Partner) sat on the board from 2014 to 2018, then was replaced by Peter May (Trian's President and a Founding Partner) from 2018 to 2022; at General Electric Edward Garden (Trian's CIO and a Founding Partner) has sat on the board since 2017; at Sysco, Nelson Peltz sat on the board from 2018 to 2021 then was replaced by Joshua Frank (Co-Head of Research and a Trian Partner) in 2021; at BNY Mellon, Edward Garden sat on the board from 2014-2019; at P&G, Nelson Peltz sat on the board from 2017 to 2021; at Family Dollar Edward Garden sat on the board from 2011 to 2015; at Pentair, Matthew Peltz (a Trian Partner) sat on the board in 2018; at Trane Technologies, Nelson Peltz sat on the board from 2012 to 2014 and at PepsiCo, Nelson Peltz sat on the board from 2015 to 2016.

Table 7 – Activist Board Representation Campaigns with Investment Periods Less than 1 year

Activist board representation campaigns initiated between 2010 and 2019 where the activist hedge fund was invested for less than one year (data on exits collected up to 30 June 2022).

	Company	Year Board Seats Sought	Activist Hedge Fund	Investment Period (years) (at 30 Jun 2022)	Ongoing or Exited (at 30 Jun 2022)
1.	Electronic Arts Inc	2011	Relational Investors	0.50	Exited
2.	Allergan Inc*	2014	Pershing Square Capital Management	0.58	Exited (acquired)
3.	Dell Inc*	2013	Icahn Enterprises	0.65	Exited (acquired)
4.	Bristol-Myers Squibb Company	2017	JANA Partners	0.75	Exited
5.	Dollar Tree Inc*	2019	Starboard Value	0.75	Exited (withdrew)
6.	Harris Corporation	2016	JANA Partners	0.76	Exited
7.	Family Dollar Stores Inc*	2015	Elliott Management	0.76	Exited (acquired)
8.	Newell Brands Inc	2018	Starboard Value	0.77	Exited
9.	The Clorox Company*	2011	Icahn Enterprises	0.84	Exited (withdrew)
10.	PetSmart Inc*	2014	JANA Partners	0.82	Exited (acquired)
11.	Sempra Energy	2018	Elliott Management	0.93	Exited
12.	Genzyme Corporation	2010	Icahn Enterprises	0.98	Exited (acquired)

Six of these twelve events were unsuccessful activist board representation campaigns (indicated with a *). As the above table shows, in these six instances, the campaigns were exited either when the activist hedge fund withdrew its campaign (2 campaigns) or when the target company was acquired (either by another listed company or by a private equity fund) (4 campaigns).[442] There is one additional campaign (Genzyme Corporation) where the activist was successful in the board representation campaign, but the company was shortly thereafter acquired.[443]

[442] Dell was taken private by founder and CEO Michael Dell and private equity firm Silver Lake Partners in 2013; Family Dollar Stores Inc was acquired by Dollar Tree Inc in 2014; Allergan was acquired by Actavis in 2015; and PetSmart was bought by a private equity consortium led by BC Partners Ltd in 2015.
[443] Genzyme was acquired by Sanofi in 2011.

However, there are five campaigns[444] where the activist secured board seats by way of settlement with the target company and nevertheless still exited the investment within a year. This was atypical in the dataset. These campaigns generally involved the activists' campaign strategies not going to plan, or they involved the activist hedge fund teaming up with a private equity partner whose representatives were on the board and who stayed invested in the company for a longer period.[445]

C. Capital Commitment

1. Methodology

I also measure and report the size of the activists' maximum stakes in the target companies, as a percentage of outstanding shares of the target company. This information comes from the Schedule 13D filing or the subsequent amendments to the 13D filings (Schedule 13D/A forms). For the non-Schedule 13D events, the information is collected from press releases, other news, or Form 13Fs. I record the highest percentage holdings by the filing party in the target company.

2. Results

The average size of an investment for successful activist board representation campaigns is 6.35% of the shares, or a median of 6.37%. If unsuccessful campaigns are included, this reduces to an average of 6.12%, or a median of 6.00%. By way of comparison, the average size of investment for non-board level campaigns is 3.65% of the shares or a median of 2.80%. This also reduces to an average of 3.52% or a median of 2.67% if the overlap cases – companies that were also targeted for board representation – are removed.

[444] Relational Investors' campaign at Electronic Arts, JANA Partners campaign at Bristol-Myers Squibb, JANA Partners campaign at Harris Company, Staboard Value's campaign at Newell Brands, and Elliott Management's campaign at Sempra Energy.

[445] For example, in Elliott Management's campaign at Sempra Energy, Elliott had joined forces with the private equity firm Bluescape Energy Partners to appoint directors to the board and persuade the company to conduct a strategic review of its business. The directors appointed to the board were affiliated with Bluescape, rather than Elliott. Elliott sold its shares less than a year later, but Bluescape remains invested in the company four years later.

Table 8 – Average Relative Size of Stake for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010-2019)

The table shows the average relative size of stake for activist board representation and non-board level campaigns at S&P 500 companies, differentiating further between successful board representation and all board representation campaigns. T-statistics and significance levels are reported for the comparisons of mean.

***T*-statistics for Comparison of Average Relative Size of Stake**					
	Mean / %	S.D. / %	*n*	*t*	*df*
Successful Board vs.	**6.35**	4.36	99	5.05***	180
All Non-Board	**3.65**	3.19	97		
All Board vs.	**6.12**	4.43	114	4.77***	204
All Non-Board	**3.65**	3.19	97		

S.D.: standard deviation, *n:* sample size, *t*: T-statistic, *df*: degrees of freedom, *, **, ***: statistically significant at $p<.05$, $p<.01$, and $p<.001$, respectively (one-tailed); means of significant differences are highlighted in bold font.

Comparison of means using a one-tailed heteroscedastic *t*-test showed that the average size of investment for successful activist board representation campaigns is significantly higher than the average size of investment for non-board level campaigns, $t(180) = 5.05$, $p < .001$, and the same held true when comparing all board representation campaigns to non-board level campaigns, $t(204) = 4.77$, $p < .001$. The same high significance levels were obtained using a two-tailed *t*-test.

Chart 8 – Average Maximum Stake for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)

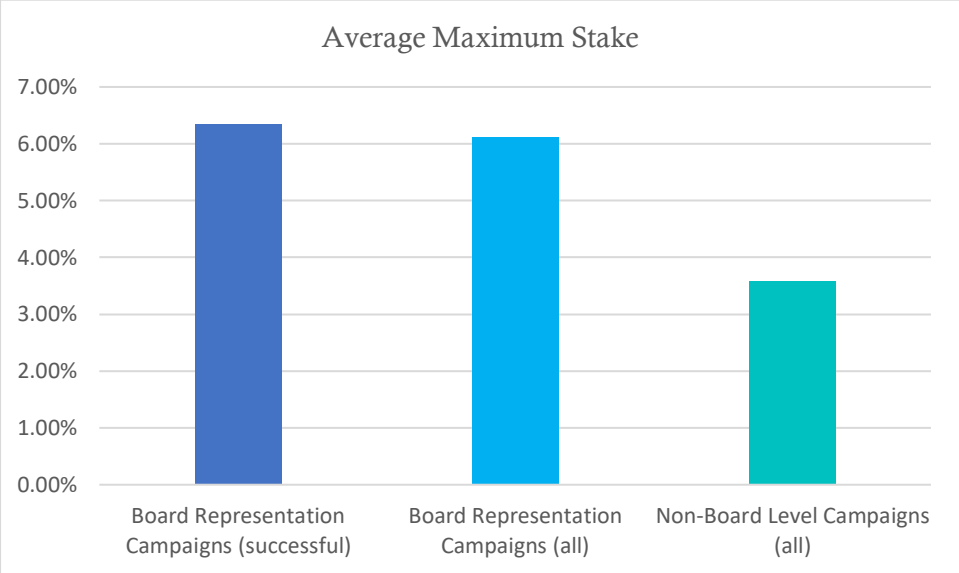
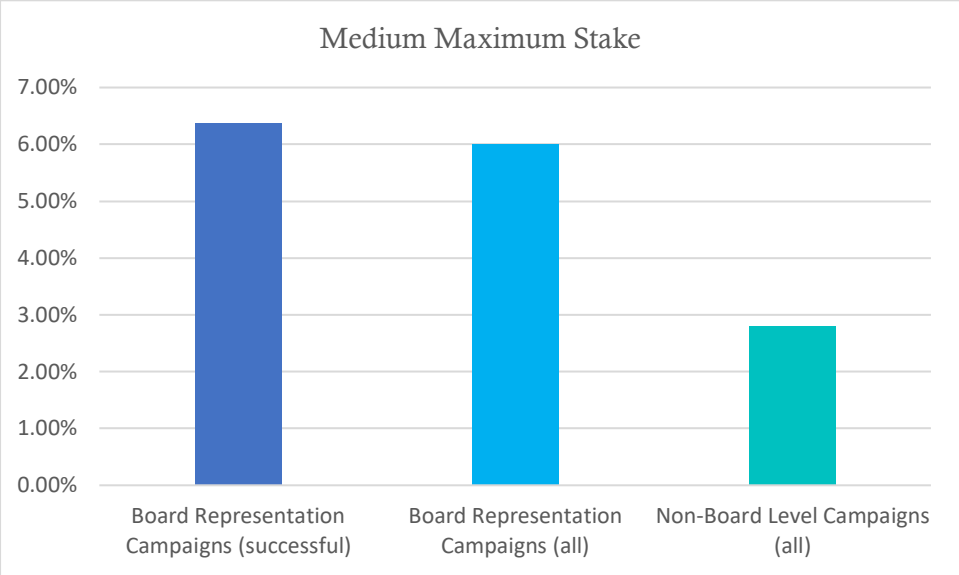
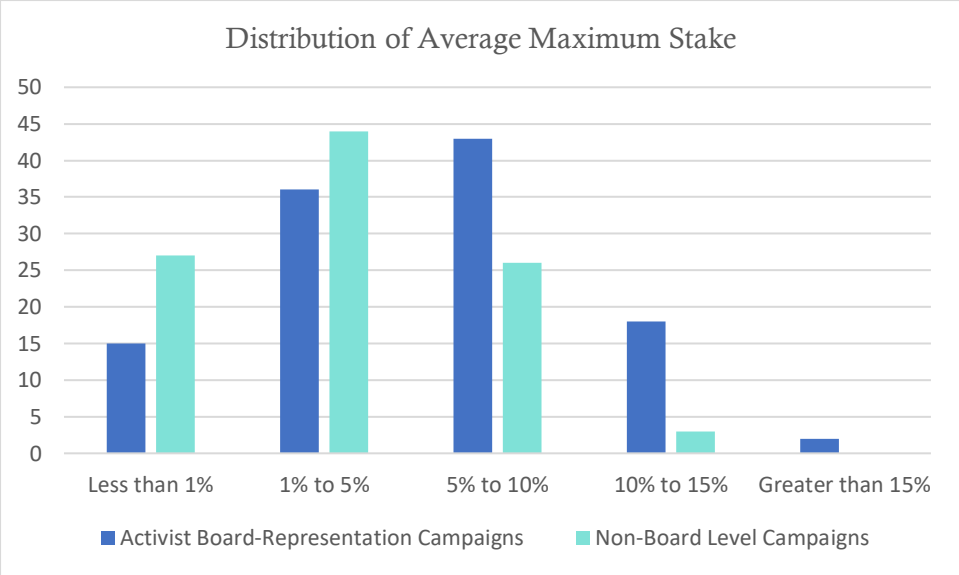


Chart 9 – Median Maximum Stake for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)



The above Charts 8 and 9 depict the average and medium stakes for activist board representation campaigns and non-board level campaigns and Chart 10 below illustrates the distribution of the average stakes that the activist hedge funds hold in their target companies.

Chart 10 – Distribution of Average Maximum Stake for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)



D. Campaign Objectives

1. Methodology

Various sources were used to discover the objectives and campaign tactics of the activist hedge fund campaigns. Firstly, in the cases where a Schedule 13D was filed, Item 4 of the Schedule 13D filing requires that the activist declare its reasons for acquiring the target company shares, "especially if its intention is to engage in a merger and acquisition activity, seek a sale of any material amount of the issuer's assets, pursue a change in its capitalization or dividend policy, or propose other types of corporate changes."[446] As a result, 13D filings are useful sources of information regarding the activists' plans. Once the initial Schedule 13D is filed, there is also a requirement for activists to promptly file Schedule 13D amendments if there is any material change in their plans for the company. Secondly, as my dataset involved such large, prominent S&P 500 companies, and mostly involved high profile activist hedge funds, many of the campaigns were publicly announced either in news articles or on specially designed websites launched by the activist hedge funds to accompany their campaign. Such websites, and the white papers or discussion papers that were often posted to these websites, gave incredibly detailed information regarding the purpose of the activist hedge funds' campaigns. Extensive searches were carried out on Google and Factiva to find relevant news articles and campaign websites. Thirdly, the Activist Insight website also contained summaries of campaign strategies used for activist campaigns at different target companies, together with links to further news articles. Combining all of these sources enabled me to build up a comprehensive picture of the strategies that were being pursued at each target company.

Therefore, beyond the categorization of campaigns into activist board representation or non-board level campaigns, I also recorded the activist hedge funds' proposed motives for each campaign. Here, I used four general categories of objectives, with various subcategories as detailed below:

[446] Brav, Jiang & Li, *Governance by Persuasion*, *supra* note 310, at 13.

Category 1 – Financial / Balance Sheet Activism

a. Dividends
b. Excess Cash / Share Repurchase
c. Capital Structure / Recapitalization
d. Sell Assets

The first category is similar to the "Capital Structure" category used in the study by Brav, Jiang, Partnoy and Thomas, where the authors recorded if the activist campaign focused on a reduction of excess cash, an increase in firm leverage, or higher payouts to shareholders using either dividends or share repurchases.[447] As noted previously, this is the most commonly criticized form of hedge fund activism that is strongly associated with the short-termist financial engineering narrative.

Category 2 – Strategic / Operational Activism

a. Business Focus
b. General Strategy / Growth Strategy
c. Operational Efficiency / Cost Cutting
d. Business Restructuring

Again, this category was relatively similar to the "Business Strategy" category used in the study by Brav, Jiang, Partnoy and Thomas. Here, the authors included general operational efficiency, cost cutting and tax efficiency-enhancing proposals within the business strategy category, as well as proposals to spin-off divisions or refocus the business strategy and playing an activist role in a pending merger or acquisition, generally by asking for a better price when the firm is the target of the acquisition or by trying to stop the pending acquisition.[448] I included spin-offs in the below category on M&A activism, but it equally could have been included in this category. I also included activist intervention in mergers and acquisitions in a separate M&A category.

[447] Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1741-1742.
[448] Id.

Category 3 – M&A Activism

a. Push for Sale of Company / Merger
b. Oppose Sale of Company / Merger
c. Spin-off / Sale of Business Division
d. Support Acquisition of Third Party
e. Oppose Acquisition of Third Party
f. Oppose Price / Terms of Merger

In study by Brav, Jiang, Partnoy and Thomas, there was a separate category for "Sale of Target Company", which included activism urging the sale of the target company either to a third party (which comprised the majority of cases) or to take over the company themselves. In the study by Brav, Jiang, Partnoy and Thomas, other mergers and acquisitions related activity was included in the "Business Strategy" category.

Category 4 – Governance Activism

a. Remove / Replace CEO
b. Separate Chairman & CEO
c. Board Composition & Independence
d. Eliminate Staggered Board
e. Other Governance

Finally, this category was also similar to the final category of "Governance" in study by Brav, Jiang, Partnoy and Thomas. In that category the authors included rescinding takeover defenses (declassifying the board or revoking poison pills), ousting the CEO or chairman, challenging board independence and fair representation, demanding more information disclosure and questioning potential fraud, and challenging the level or pay-for-performance sensitivity of executive compensation.[449]

When analyzing the campaign strategies, I excluded from the total number of events multiple campaigns at the same company, and the non-board level campaigns at

[449] *Id.*

companies that were also targets of activist board representation, to avoid double-counting strategies or outcomes. Therefore, the total number of events was 189 as the total number of activist board representation events was 115 (rather than 126) and the total number of non-board level events was 74 (rather than 102).

2. Results

Table 9 – Summary of Events by Activist Hedge Fund Campaign Objective

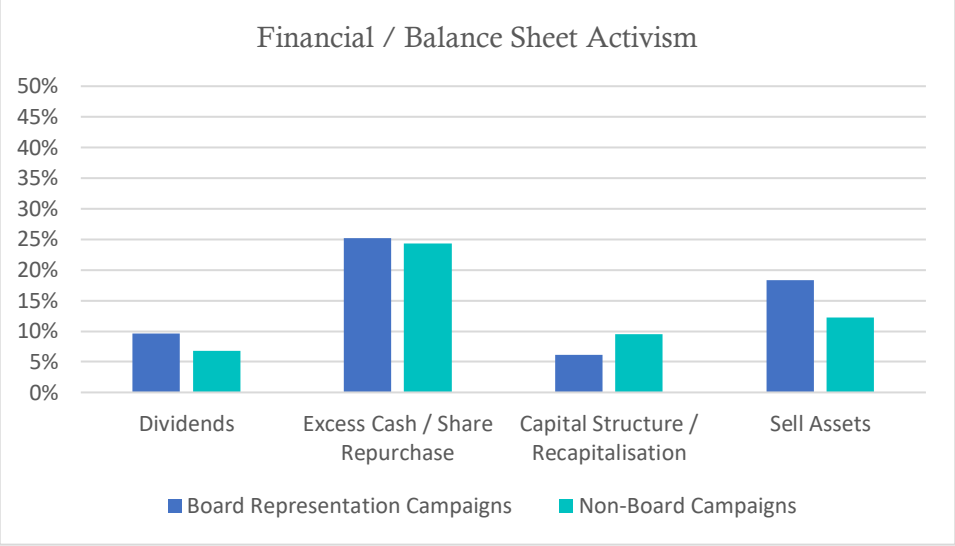
This table includes 189 events. The table reports the summary of the events sorted by hedge funds' campaign objectives. Columns 1 and 2 report the number of events, and the percentage among all events, of each category. Columns 3 and 4 list the number of events, and the percentage among all events, for activist board representation campaigns. Columns 5 and 6 list the number of events, and the percentage among all events, for non-board level campaigns (where the target company was also not the target of an activist board representation campaign). Percentages sum up to more than 100% since one event can have multiple objectives.

	All Events		**Board Representation Campaigns**		**Non-Board Campaigns**	**Level**
Categories	**Number of Events (1)**	**% of Sample (2)**	**Number of Events (3)**	**% of Cases (4)**	**Number of Events (5)**	**% of Cases (6)**
Financial/Balance Sheet Activism						
Dividends	16	8.5%	11	9.6%	5	6.8%
Excess Cash / Share Repurchase	47	24.9%	29	25.2%	18	24.3%
Capital Structure / Recapitalization	14	7.4%	7	6.1%	7	9.5%
Sell Assets	30	15.9%	21	18.3%	9	12.2%
Strategic / Operational Activism						
Business Focus	24	12.7%	23	20%	1	1.4%
General Strategy / Growth Strategy	50	26.4%	47	40.9%	3	4.1%
Operational Efficiency / Cost Cutting	55	29.1%	48	41.7%	7	9.5%
Business Restructuring	31	16.4%	27	23.5%	4	5.4%
M&A Activism						
Push for Sale of Company / Merger	49	25.9%	27	23.5%	22	29.7%

Oppose Sale of Company / Merger	5	2.6%	3	2.6%	2	2.7%
Spin-off / Sale of Business Division	60	31.7%	43	37.4%	17	23%
Support Acquisition of Third Party	9	4.8%	4	3.5%	5	6.8%
Oppose Acquisition of Third Party	12	6.3%	3	2.6%	9	12.2%
Oppose Price / Terms of Merger	3	1.6%	1	0.9%	2	2.7%
Governance Activism						
Remove / Replace CEO	34	18%	31	27%	3	4.1%
Separate Chairman & CEO	4	2.1%	4	3.5%	0	0%
Board Composition and Independence	20	10.6%	15	13%	5	6.8%
Eliminate Staggered Board	6	3.2%	5	4.3%	1	1.4%
Other Governance	41	21.7%	35	30.4%	6	8.1%

The below charts illustrate the comparisons in campaign strategies between activist board representation campaigns and non-board level campaigns.

Chart 11 – Financial or Balance Sheet Activism for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)

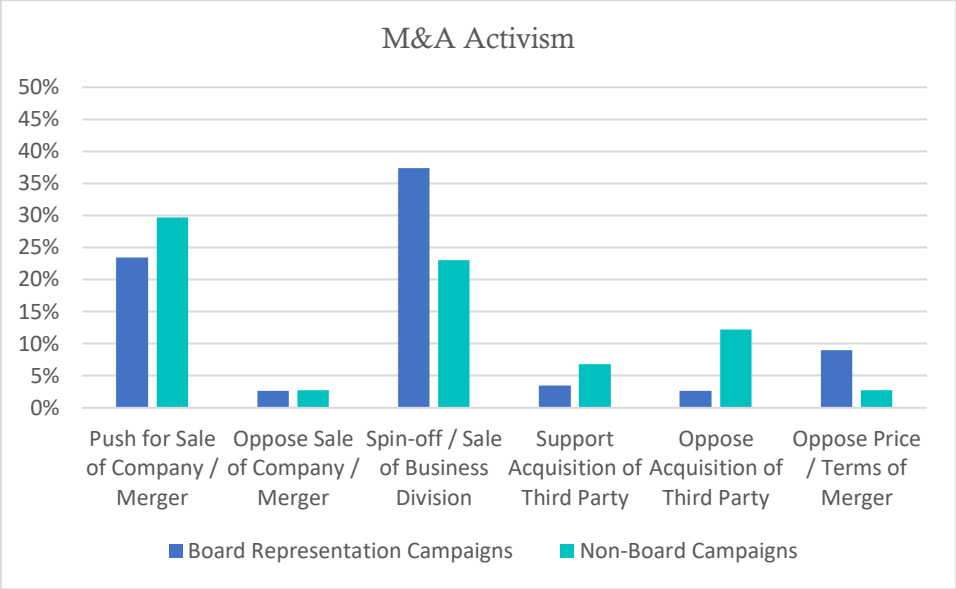


Firstly, for financial or balance sheet activism, activist board representation campaigns and non-board level campaigns present reasonably similarly. The only major difference is a slightly higher incidence of campaigns where the activist pushes for the company to sell assets when they also campaign for board representation (18.3% of campaigns compared to 12.2% of campaigns).

Chart 12 – Strategic and Operational Activism for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)

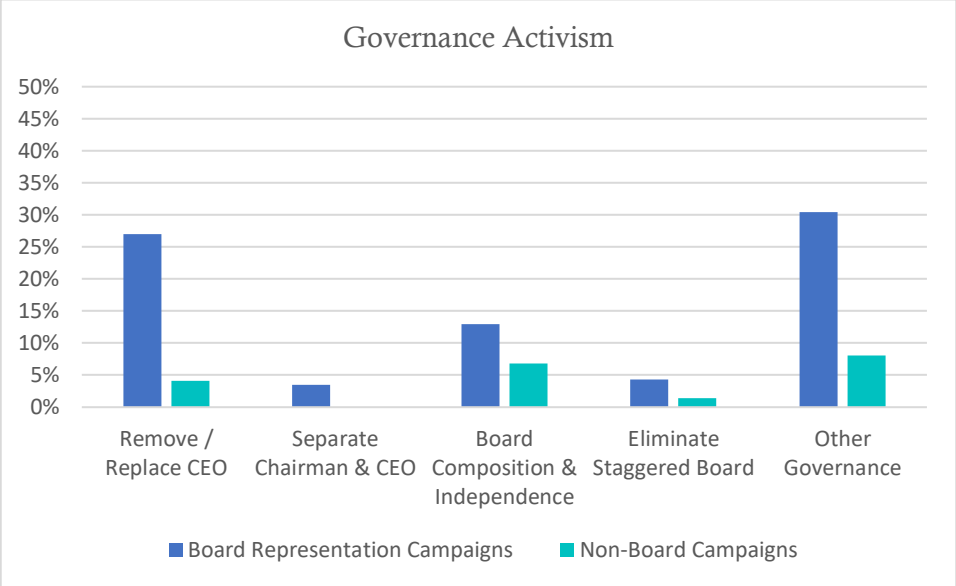
For strategic and operational activism, there are major differences between the strategies campaigned for in activist board representation campaigns compared with non-board level campaigns. The chart shows that strategic and operational activism is almost always accompanied by a request for activist board representation.

Chart 13 – M&A Activism for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)



For M&A activism, there are not major differences, although there is a larger proportion of activist board representation campaigns that advocate for spin-offs or sale of business divisions (37.4% compared to 23% of cases). As noted earlier, spin-offs could have been included within the strategic and operational activism category.

Chart 14 – Governance Activism for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)



Finally, for governance activism, hedge fund activists are much more likely to campaign to replace the CEO when they are requesting board representation. In 27% of cases

involving activist board representation, there is also a request to replace the CEO, compared to only 4.1% of non-board level campaigns.

In the study by Brav, Jiang, Partnoy and Thomas, it was highlighted that different types of campaign objectives generate different abnormal returns for activists. In their 2001 to 2006 data, M&A activism that was aimed at selling the target company proved to generate the highest abnormal returns, with an average of 8.54%. Activism associated with business strategy also generated high returns, averaging 5.95%. By contrast, activism targeting capital structure and governance issues generated smaller average returns for hedge funds, at 1.47% and 1.73%.[450]

E. CEO Turnover

1. Methodology

In Section D above, it was noted that in 27% of campaigns involving activist board representation, there was a request to replace the CEO, compared to only 4.1% of non-board level campaigns. As requests to replace the CEO seemed a particularly common campaign strategy for activist board representation campaigns, I also analyzed the outcome of these campaigns, in terms of whether the CEO was ultimately replaced while the activist intervention was ongoing.

Data on CEO replacements could be gleaned from analyzing the Form 8-K filings for the relevant companies and also by conducting google and news searches. The departure of CEOs from S&P 500 companies was always reported in the media, so it was relatively easy to collect information on the dates CEOs stood down and to confirm this using the official Form 8-K filings available from the SEC Edgar Database.

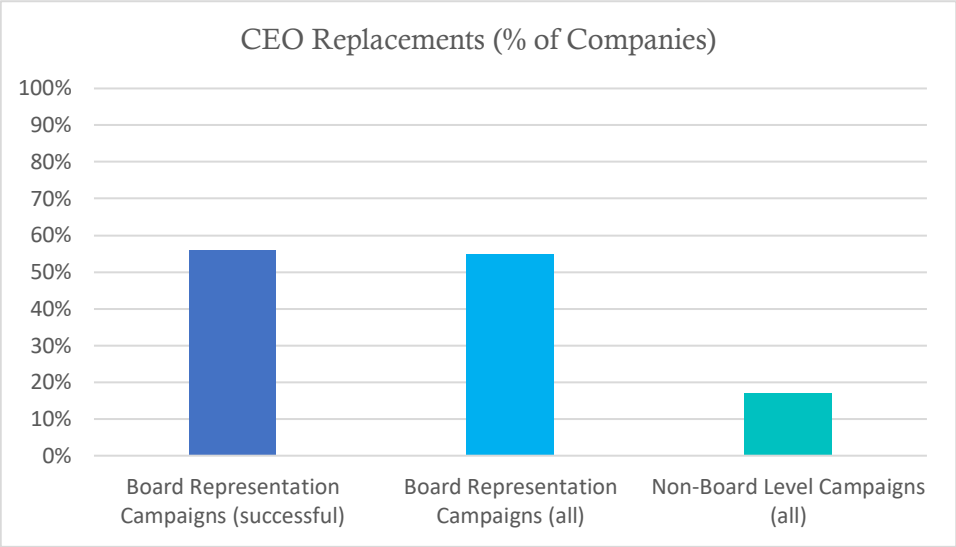
2. Results

During the activists' tenure, there were 68 new CEOs at the 101 companies that were targets of activist board representation (68 out of 112 events, or 61% of events, as joint

[450] Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1759.

campaigns were excluded). At 55% of these 101 companies (56 companies), the CEO was replaced at least once during the activist's tenure. The number of actual CEO replacements is higher than the number of companies where the CEO was replaced, because there were multiple CEO replacements at ten companies.[451] If only successful activist board representation campaigns are included, the CEO was replaced at 56% of companies successfully targeted (50 out of 90 companies). In non-board level activist campaigns, the CEO was replaced in 17% of campaigns (11 out of 64 companies) and 15% of events (11 out of 74 events), as illustrated in Chart 13 below.

Chart 15 – Percentage of Companies with CEO Replacements for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)

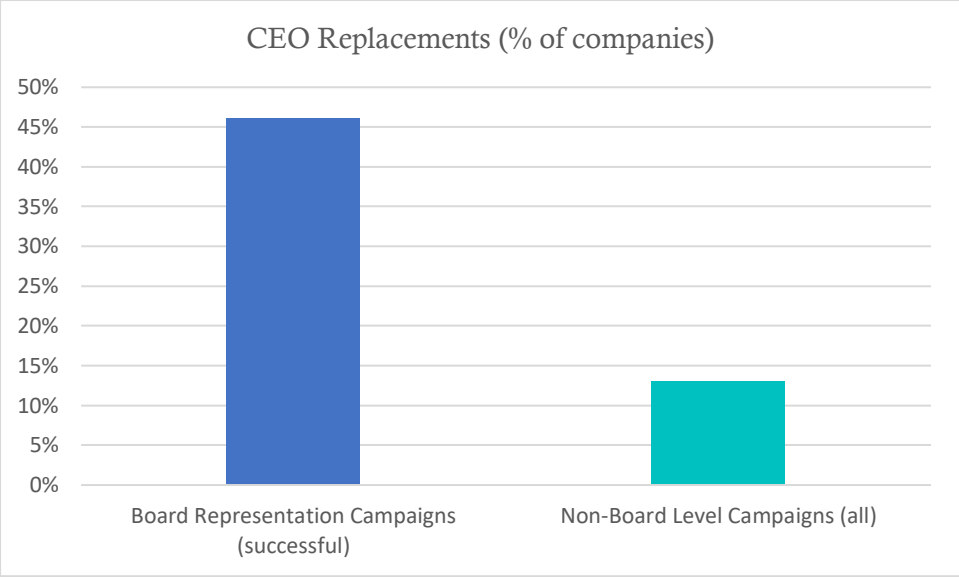


One plausible interpretation of this data would be that if activist board representation campaigns have a longer investment period, the CEO is more likely to be replaced during the activist's tenure. Other studies have examined whether CEOs have stood down within a certain time period after activist intervention. For example, in the Brav et al study, they

[451] At Alliance Data Systems, the CEO was replaced twice in 2019 during ValueAct Capital's tenure, at Arconic (now Howmet Aerospace), the CEO was replaced four times during Elliott Management's tenure (in 2016, 2017, 2018 and 2019), at Citrix Systems, the CEO was replaced twice during Elliott Management's tenure (in 2015 and 2017), at CSX Corporation the CEO was replaced twice in 2017 during Mantle Ridge's tenure, at Iron Mountain, the CEO was replaced twice during Elliott Management's tenure (in 2011 and 2012), at JC Penney Company, the CEO was replaced twice during Pershing Square Capital Management's tenure (in 2011 and 2013), at Perrigo Company, the CEO was replaced twice during Starboard Value's tenure (in 2017 and 2018), at Wells Fargo, the CEO was replaced twice during GAMCO's tenure (in 2016 and 2019), at Xerox, the CEO was replaced twice during Carl Ichan's tenure (in 2016 and 2018) and at Yahoo!, the CEO was replaced twice during Third Point's tenure (in 2012 and 2017).

noted that "during the year after the announcement of activism…the CEO turnover rate increases by almost 10 percentage points" for their sample of activist events from 2001 to 2006.[452] Therefore, I also collected data on how soon CEOs left after the activists were granted board seats, and in particular whether CEOs stood down within a year of the activist being granted board seats.

Chart 16 – Percentage of Companies with CEO Replacements within One Year for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)



In 46% of companies where activists were successful in securing board seats, the CEO stood down either shortly before board seats were granted to the activist or within one year of the board seats being granted (41 out of 90 companies). Similarly, if this exercise is repeated for the non-board level campaigns (measuring from the date of activist involvement, rather than when the board seats were granted), the percentage of non-board level campaigns where CEO exited within one year of activist involvement is 13% (8 out of 64 companies).

A 2021 report by Lazard outlines that the baseline CEO turnover for S&P 500 companies is between 10% and 12% each year.[453] Therefore, it seems that non-board level activism

[452] Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1732.
[453] LAZARD, 2021 REVIEW OF SHAREHOLDER ACTIVISM, 16, https://www.lazard.com/media/451963/lazards-q4-2021-review-of-shareholder-activism_vf.pdf.

does not have much effect on CEO turnover, whereas activist board representation increases the likelihood of CEO turnover significantly.

As noted in Chapter 3, activist hedge fund campaigns are not thought to be kind to CEOs of target firms.[454] The above data on CEO turnover shows that hedge fund activism is much less kind to CEOs when activists seek and secure board representation, compared to cases where there is no activist board representation.

F. Types of Activist Director

1. Methodology

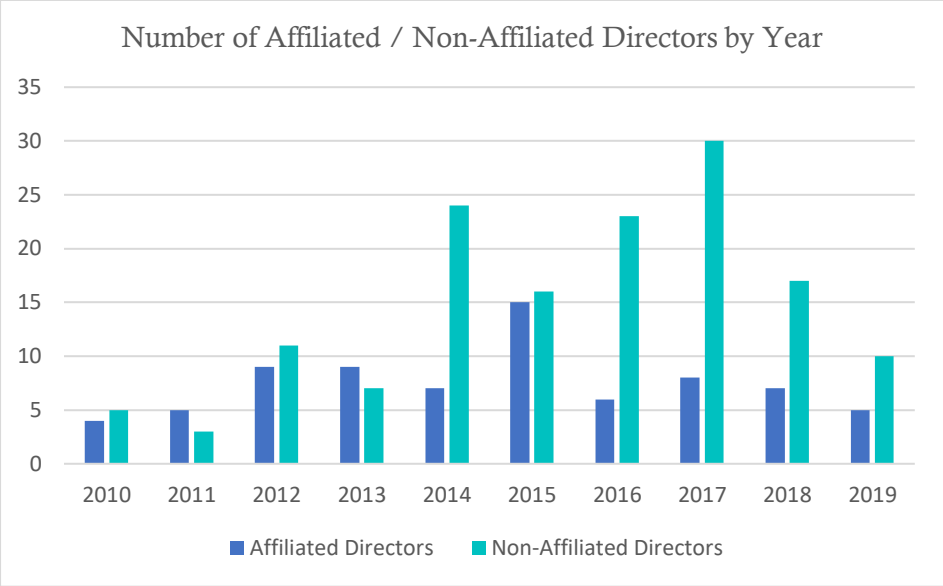
As noted in Chapter 3, activist director nominees can either be affiliated directors who work at the activist hedge fund, or non-affiliated directors who are selected by the hedge fund. I recorded data on whether each director who secured a board seat was affiliated or non-affiliated with the hedge fund. This information was readily obtainable from news reports publicizing the appointment of the directors, and this information was also confirmed by checking the official Form 8-K filing with the SEC. Whether a director was affiliated or non-affiliated was also simple to ascertain simply by conducting a google search of who the director was. This information was also often reported in settlement agreements negotiated between the activist hedge fund and the target company. Therefore, there were many different ways to verify the information regarding the relevant director's affiliation.

2. Results

Of the 218 board seats gained by hedge fund activists at S&P 500 companies in campaigns launched between 2010 and 2019, 74 seats (34%) were secured by directors affiliated with the activist hedge funds and 144 seats (66%) were secured by non-affiliated directors. Although there is some variability from year to year, in the more recent years of the sample, the proportion of affiliated directors has generally decreased, as shown in the chart below.

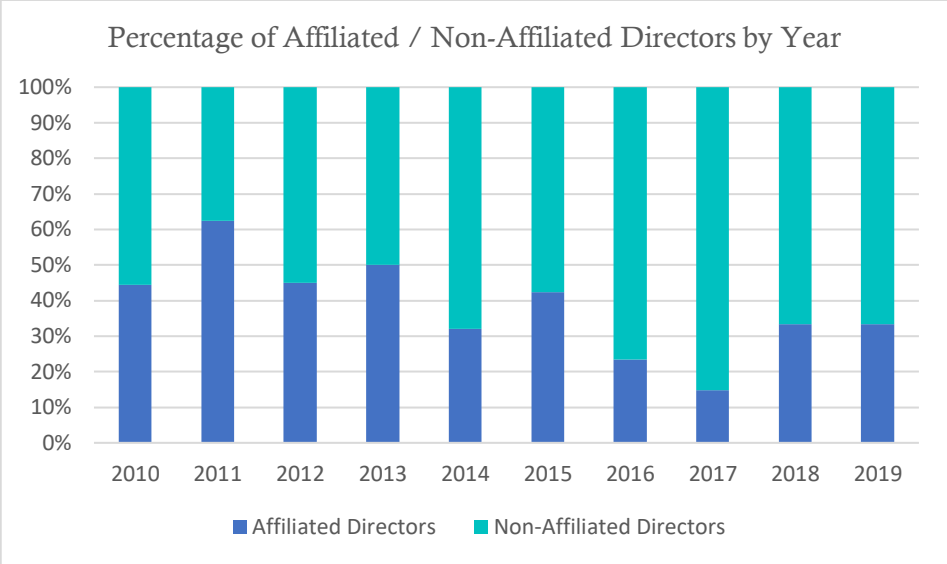
[454] *See infra* Chapter 3, Section II. E. (citing Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1732).

Chart 17 – Number of Affiliated and Non-Affiliated Directors by Year for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)



The clear trend, therefore, is towards the appointment of non-affiliated director as opposed to hedge fund principals themselves taking seats on boards. In each year of the sample campaigns since 2014, the number of non-affiliated directors has been higher than the number of affiliated directors. In some campaigns there were a mix of affiliated and non-affiliated directors appointed.

Chart 18 – Percentage of Affiliated and Non-Affiliated Directors by Year for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)



The appointment of affiliated or non-affiliated directors does, however, tend to vary by hedge fund. For example, Trian Fund Management and ValueAct Capital Partners always had at least one affiliated director on the board of target companies, without exception. Indeed, Trian exclusively put affiliated directors on the boards (which was atypical behavior compared to other activist hedge funds).[455] By way of comparison, in almost all of Elliott Management's campaigns, non-affiliated directors were appointed, rather than representatives from the hedge fund itself.

Activist hedge funds tended to stay invested in target companies longer when there was at least one affiliated director on the board. The average investment period for campaigns where at least one affiliated director was appointed was 3 years and 9 months (3.79 years) compared to 2 years and 8 months (2.70 years) when only non-affiliated directors were on the board.

[455] In each of the successful campaigns initiated by Trian Fund Management at S&P 500 companies from 2010 to 2019, the appointed directors were fund principals at Trian. These individuals included Nelson Peltz (Trian's CEO and Founding Partner), as well as other Partners of Trian.

G. Activist Settlements

1. Methodology

As noted earlier, activist campaigns can either proceed to a shareholder vote through a proxy contest, or be settled by a negotiated agreement between the activist hedge fund and the target company. Proxy contests were heavily publicized and reported, and were also detailed in the Activist Insight database. Settlement agreements are filed with the SEC, so they are also publicly available.

2. Results

In my dataset, 85% of events where activists sought board representation were settled (107 of 126 events). There were only eight events (6% of the activist board representation campaigns) at seven companies in my sample that proceeded to a proxy contest.[456] All of the other board seats were gained through settlements. Additionally, one of the proxy contests – Trian Management's campaign at Procter & Gamble in 2017 – also ultimately resulted in a settlement agreement. Only twelve events involved the activist hedge fund withdrawing or the campaign being unresolved and one of the cases of withdrawal also resulted in a later settlement agreement (Carl Icahn's campaign at TEGNA Inc).[457]

In terms of the actual number of seats gained via settlements compared to via proxy contests, of the 216 board seats gained, only 14 board seats (6.5%) were gained via proxy contests, compared to 202 board seats (93.5%) being secured via settlement agreements. The 14 seats for proxy contests are also heavily skewed by the 12 board seats won by Starboard Value in its campaign at Darden Restaurants in 2014. The other two board seats secured via a proxy contest were Carl Icahn's campaign at Forest Laboratories in 2012, and Ader Investment Management's campaign at International Game Technology plc in 2013. Therefore, in my dataset, no board seats were won at S&P 500 companies by activist

[456] The companies were Forest Laboratories (Icahn Enterprises) in 2011 and 2012, International Game Technology (Ader Group) in 2013, Darden Restaurants (Starboard Value) in 2014, DuPont (Trian Fund Management) in 2015, General Motors (Greenlight Capital Management) in 2017, Procter & Gamble (Trian Fund Management) in 2017, Automatic Data Processing (Pershing Square) in 2017. Between 2020 and 2023, after my sample period ended, there have only been two additional proxy contests at S&P 500 companies and both concerned ESG issues. These campaigns were Engine No. 1's campaign at ExxonMobil in 2021 and Icahn Enterprises' campaign at McDonald's in 2022.

[457] Albeit not one where the activist secured board representation.

hedge funds through proxy contests since 2014. This shows how rare proxy contests are compared to negotiated settlements, at least for the major activist hedge funds who have initiated campaigns at the biggest companies in the United States. It also shows that when a target company does choose to fight an activist intervention for board seats, there is a reasonable chance of success. In the four proxy contests that were fought in the dataset since 2014, the activist hedge fund was not successful in the shareholder vote. These campaigns were Trian Fund Management's campaign at DuPont in 2015, Trian Fund Management's campaign at Procter & Gamble in 2017, Greenlight Capital's proxy contest at General Motors in 2017, and Pershing Square Capital's proxy contest at Automatic Data Processing in 2017. Since the cutoff point in my dataset (campaigns initiated before 2020), there has been one other activist hedge fund campaign which proceeded to a full shareholder vote where the activist hedge fund successfully won seats. This was Engine No. 1's campaign at ExxonMobil in 2021, which is discussed in full in Part III of this thesis.

III. DISCUSSION AND IMPLICATIONS

A. Safeguards

1. Minority Board Representation

The empirical study above has suggested some likely virtues of activist board representation, especially in terms of the activist hedge funds having a more long-term investment horizon and potentially focusing on sustainable value creation through strategic and operational improvements. Of course, not all cases of activist board representation will have a positive impact on target companies.[458] However, there are some safeguards inherent in activist board representation that would not, for example, be the case for actors who take full control of the board, as the corporate raiders did in the 1980s. The criticisms directed at activist hedge funds are often similar to those made of corporate raiders (some of whom reinvented themselves as hedge fund activists). In the early stages of activist board representation, it was noted that "hedge funds seek to elect a short slate

[458] A commonly cited example of destructive hedge fund activism involving board representation is Pershing Square's investment in J.C. Penney, where Bill Ackman of Pershing Square was appointed to the board. Coffee and Palia describe this case as "the best known example of a financial disaster caused by aggressive intervention by hedge funds" as J.C. Penney's stock price fell almost 60% between the initial Schedule 13D filing and Ackman's eventual resignation from the board. *See* Coffee & Palia, *supra* note 56, at 584.

of directors rather than seeking majority control of the board."[459] There are certainly examples of activist hedge funds attempting to overthrow entire boards. Starboard Value's successful campaign at Darden Restaurants has already been highlighted. There were also other campaigns at Yahoo! – where the activist hedge fund Starboard Value launched a proxy contest in 2016 to replace the entire board, including CEO Marissa Mayer[460] – and at Newell Brands – where Starboard Value again nominated a full slate of candidates to the board in 2018, including two directors who had very recently resigned from the board.[461] However, activist campaigns to take full control of corporate boards are very rare. In cases where activist hedge funds secure board representation, this is almost always a minority of the overall board. In my sample, although activist hedge fund activists secured between one and twelve board seats in their successful campaigns, the average number of board seats they secured (either for themselves or for non-affiliated directors) was two. Only eleven campaigns out of 110 successful activist board representation campaigns (10%) involved the activist securing more than three board seats,[462] and the case of Darden where the entire board was replaced was a clear outlier.

There are various levels of safeguards against "bad" cases of activist board representation. First, if activists seek minority board representation, they first have to persuade other shareholders to support their director nominees. This is obviously the case when there is a proxy contest and shareholder vote. However, as outlined earlier, most activist board representation campaigns result in a settlement between the target company and the activist, rather than proceeding to a shareholder vote. Indeed, securing minority board representation by way of negotiated settlement is a much cheaper alternative both for the activist and the company, rather than engaging in a proxy contest. Nevertheless, there are also potential safeguards when activists and target companies enter into a negotiated

[459] Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism*, *supra* note 277, at 1748.
[460] *See* Michael Flaherty & Supanta Mukherjee, *Starboard launches proxy fight to remove entire Yahoo board*, REUTERS (Mar. 29, 2016), https://www.reuters.com/article/us-yahoo-starboard-proxy-idUSKCN0WQ0D7.
[461] Nivedita Balu, Vibhuti Sharma & Harry Brumpton, *Starboard nominates candidates to replace Newell's board*, REUTERS (Feb. 12, 2018), https://www.reuters.com/article/us-newell-brands-starboard-idUSKBN1FW1G0.
[462] Starboard Value at Cerner Corporation (4 seats), Carl Icahn at Chesapeake Energy Corporation (4 seats), Mantle Ridge at CSX Corporation (5 seats), Starboard Value at Darden Restaurants (12 seats), Third Point at The Dow Chemical Company (4 seats), Carl Icahn at Newell Brands (4 seats), Starboard Value at Perrigo Company (5 seats), Starboard Value at Symantec Corporation (now NortonLifeLock) (4 seats), Carl Icahn at Xerox (5 seats), Third Point Partners at Yahoo! (4 seats) and Starboard Value at Yahoo! (4 seats). *See infra* Appendix A for details of activist board representation campaigns in the dataset.

settlement to appoint activist directors. Target company managers will often seek the views of other long-term shareholders on the proposed candidates. As outlined earlier, global asset managers and other long-term shareholders are increasingly insisting that companies do so before settling with activists.[463]

Moreover, once activist directors are appointed, they will still need to convince the rest of the board to implement any proposed new strategies or changes (whether the director is affiliated with the activist hedge fund or not).[464] As Bebchuk, Brav, Jiang and Keusch note, this situation differs from the corporate raiders of the 1980s who sought outright control of boards.[465] Therefore, there are various layers of safeguards to protect against "bad activism" or short-term strategies on the part of activist hedge fund nominees. Activist directors cannot act alone or push through strategies unless the rest of the board agrees.

2. The Role of Institutional Investors

Relatedly, as mentioned above, institutional investors play an increasingly important role as corporate governance intermediaries in activist campaigns. As demonstrated in the empirical study, the average activist hedge fund holding in activist board representation campaigns at S&P 500 companies is just over 6%. Therefore, support from institutional investors who hold a much larger proportion of the shares tends to be necessarily for any activist campaign to succeed.[466] Institutional investors therefore provide valuable support to activists and operate as an important safeguard if activist proposals are not in the best interests of the long-term success of the company.

Activist board representation is, however, a specific type of intervention that may appeal to longer-term institutional investors, as when activist hedge funds secure board representation they generally hold shares for longer periods compared to situations where no board representation is involved. The longer-term and more substantive commitment evidenced by activist hedge funds in such campaigns therefore mitigate some of the common concerns of financial wizardry associated with the perceived short-term "hit-and-

[463] *See infra* Chapter 3, Section II. G.
[464] Bebchuk, Brav, Jiang & Keusch, *Dancing with Activists*, *supra* note 302, at 22.
[465] *Id*.
[466] 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, 896-901 (2013) [hereinafter *Agency Capitalism*].

run" motives of activist hedge funds. Activist hedge funds are also unique in pursuing this form of firm-specific activism that other investors are unlikely to have the capacity or the incentives to initiate. No other activist specializes in the appointment of activist directors who focus on strategy, operations, and turnaround. Activist board representation as a strategy has grown alongside the rise in power of institutional investors, which also may explain why it has become a more common strategy, especially at S&P 500 companies that tend to have particularly large institutional investor holdings.

B. The Role of Activist Directors on the Board

As noted earlier, most directors appointed by activist hedge funds are non-affiliated directors. When proposing director nominees, activist hedge funds often criticize the industry expertise of the current board, which was already identified as a potential issue with the part-time independent directors who feature prominently in the monitoring board model. This can result in the activist nominating industry experts or even former CEOs of the company, or experts in turnaround. There is usually a clear focus on strategy and operations and a motivation for the new directors to get involved in that strategy in order to improve corporate performance.

For example, when Jana Partners announced that it had added three directors to the board of Tiffany & Co, through a settlement agreement with the company, the executives appointed were all industry specialists who were not affiliated with the hedge fund. The appointees were Francesco Trapani, the ex-CEO of luxury retailer Bulgari, Roger Farah, the co-CEO of luxury brand Tory Burch and James Lillie, a former CEO of the consumer products company Jarden Corp.[467] One of the directors (Trapani) was announced as joining Tiffany's CEO search committee and another of the directors (Farah) became Chairman of the board. As an aside, there were some suggestions at the time that the true motivation of the activist hedge fund may have been to push for Tiffany to be a takeover target. In particular, it was noted in the media coverage that two of the new directors who were appointed by Jana had a history of dealmaking, with Trapani having been the CEO of Bulgari when LVMH agreed to buy the company for $5 billion, and Lillie being the

[467] Flaherty, *supra* note 364.

CEO of Jarden when it was acquired by Newell Brands.[468] However, Jana exited its investment in Tiffany in May 2019 before any takeover was announced. The appointed directors continued in post after Jana's exit, which is common with non-affiliated directors. An M&A deal did ultimately materialize, with LVMH announcing in November 2019 that it would acquire Tiffany for $16.6 billion, as the largest luxury products M&A deal in history.[469] The role of activist directors in M&A is an avenue for future work that is outside the scope of this thesis.

Overall, however, the activist directors nominated to target company boards may have deep industry expertise and therefore in some respects more closely resemble the directors of the old advisory board, rather than the monitoring board. This exposes some of the deficiencies of the monitoring board, as discussed earlier, and illustrates that there may be role for directors with greater industry knowledge or even firm-specific expertise (in the case of former CEOs of the company) on corporate boards. This may especially be the case if we reimagine the role of the board to focus more on strategy and management, as well as monitoring.

C. Board Representation by Other Investors

The major shareholder protagonists that appoint minority directors to boards are activist hedge funds, to the extent that board representation campaigns are now the most common type of hedge fund activism at S&P 500 companies. As outlined in Chapter 1, there were various proposals from scholars for institutional investors to become more involved in the nomination of directors. Board representation campaigns are not limited to activist hedge funds. As briefly explained earlier in this chapter, I excluded campaigns by other shareholders from the dataset. However, there are various reasons why activist hedge funds are the primary instigators of activist board representation campaigns. It is more challenging for other types of shareholders to nominate directors to corporate boards for various reasons. One significant reason is the costs involved in doing so, as outlined earlier.[470] Of course, it has already been shown that most activist hedge fund board

[468] Id.
[469] Lex team, *LVMH/Tiffany: diamond geezer*, FIN. TIMES (Nov. 25, 2019) https://www.ft.com/content/7753ac63-c686-4dc8-9b19-6c17a00679a2.
[470] *See infra* Chapter 3, Section II. G.

representation campaigns – at least when they involve major hedge funds targeting S&P 500 companies – are settled rather than requiring a proxy contest or proceeding to a full shareholder vote. However, that tends to be the case only for established players who already have a reputation for running successful activist board representation campaigns. The high costs involved in making a credible threat of a proxy contest means that there is a very small group of activist hedge funds that can successfully pursue activist board representation campaigns. As the data showed, between 2010 and 2019, only thirteen activist hedge funds initiated more than one board representation campaign at an S&P 500 company and seven activist hedge funds (Icahn Enterprises, Elliott Management, Trian Fund Management, ValueAct Capital Partners, Starboard Value, JANA Partners and Pershing Square Capital Management) were responsible for more than 72 percent of all activist board representation campaigns at S&P 500 companies. Therefore, the strategy of seeking and securing board representation is somewhat restricted to the largest and most formidable activist hedge funds. New entrants or other investors may have to launch and conduct a full proxy contest in order to establish a reputation and to have future campaigns taken seriously by large corporations. An example of this was the newly established activist fund Engine No. 1's campaign at Exxon,[471] which involved the fund reportedly spending approximately $30 million on their proxy contest.[472] Such costs are prohibitively expensive for most investors, who may have to pursue different strategies if they are seeking a refresh of the board. It is much more common for other investors (including non-governmental organizations, public pension funds, labor unions, religious organizations or individual "gadfly" investors) to pursue their activist campaigns through the shareholder proposal mechanism, rather than by nominating directors to corporate boards.[473] Why do activist hedge funds still pursue board representation despite the high costs involved in these types of interventions that prove to be a major impediment for other types of investors? Activist hedge funds have stronger incentives to pursue costlier forms of activism because their concentrated holdings in a small number of portfolio companies, and their compensation structure, means that they can effectively capture a significant proportion of value generating strategies.

[471] *See infra* Chapter 6.
[472] Jennifer Hiller & Svea Herbst-Bayliss, *Exxon, activist spend over $65 mln in battle for oil giant's future*, REUTERS (Apr. 15, 2021) https://www.reuters.com/business/energy/exxon-activist-spend-over-65-mln-battle-oil-giants-future-2021-04-15/.
[473] *See infra* Chapter 7.

D. Generalizability of Results

This empirical study focused on activist board representation at S&P 500 companies. It is an open question whether the findings of the dataset could be generalized to a wider universe of companies in the United States. This would involve further data collection and analysis. There are likely to be some similar features of campaigns, especially if the same activist hedge funds are involved. However, a broader range of activist hedge funds target smaller companies, so there may well be some divergence in the particular strategies and other aspects of the campaigns.

In terms of generalization to campaigns in other countries, for the reasons stated at the outset in the introduction, this thesis focuses on activist hedge fund campaigns in the United States. The prevalence and relative success of activist hedge fund board representation campaigns varies considerably by jurisdiction. While activist board representation campaigns are very common in the U.S., even at large S&P 500 companies, less than 10 FTSE 350 companies have been similarly targeted in the U.K. over the same time period since 2010.[474] Campaigns in continental Europe can be even more complex still, especially if there is a two-tier board structure or if companies have controlling shareholders. Recent analysis by Activist Insight has shown that in 2021 there were 86 campaigns for activist board representation[475] in the U.S. compared to 47 campaigns in the whole of Europe (including the U.K.).[476] These numbers decreased since 2018 when there were 172 activist board representation campaigns in the U.S. and 74 campaigns in Europe.[477] Nevertheless, it is clear that activist board representation is a phenomenon that is much more prevalent in the U.S. than in other jurisdictions. There are various potential legal and other reasons for this. One overarching reason is simply that activist hedge fund campaigns more generally are more common in the U.S., but there are additional reasons why board level activism may not work so well as a strategy for activist hedge funds in other jurisdictions. A comparative analysis is outwith the scope of this thesis but is a potential avenue for future work.

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[474] Targets included National Express Group (Elliott Management) in 2011, Vesuvius (Cevian Capital) in 2012, Rolls-Royce (ValueAct) in 2015, Alliance Trust (Elliott Management) in 2015, Barclays (Sherborne Investors) in 2019 and FirstGroup (Coast Capital) in 2019.
[475] That either resulted in a settlement or went to a shareholder vote.
[476] Activist Insight, The Activist Investing Annual Review (2022) https://www.activistinsight.com/aiar_22/.
[477] *Id.*

Conclusion

Part II examined hedge fund activism at S&P 500 companies, in particular how activist board representation campaigns may involve different tactics or investment periods to non-board level campaigns. The empirical study demonstrated that S&P 500 companies are now being targeted in a manner that they were not before. Activist board representation campaigns were rare prior to 2010, but over the past decade they have become a core feature of hedge fund activism at America's largest companies. The results have already been summarized but it is clear that seeking and securing board representation is now the strategy of choice for a small group of the largest and most formidable activist hedge funds. These campaigns have high success rates, meaning that activist hedge fund managers or their non-affiliated representatives have joined the boardrooms of some of America's largest and most well-known companies. The data showed that when hedge funds secure board representation, the average duration of their investment in the target company is longer than that previously reported for hedge fund activist campaigns, and also much longer than non-board level campaigns at S&P 500 companies. As well as being more long-term, it was clear from the data that activist board representation campaigns also tend to focus on strategic and operational goals, meaning that they may not fit the pattern of the types of hedge fund campaigns that are vilified in the media as being short-termist. Activist board representation also commonly results in the departure of the CEO. In nearly half of successful activist board representation campaigns, the CEO stood down within a year. Some cynicism may remain regarding the activities of activist hedge funds and their nominee directors. For example, it is an open question whether some activist board representation campaigns may more focused on M&A activism, rather than strategic and operational changes. Certainly, the number of cases involving the activist pushing for the sale of the company or involving spin-offs, was high. M&A activism has previously been shown to create the most value for hedge fund investors. Once more time has passed since these interventions, it could also be studied what the eventual outcomes were at each target company.

Part II also links back to Part I, where it was outlined in Chapter 1 that activist board representation exposes some of the deficiencies associated with the independent monitoring board. When hedge fund managers are appointed to boards, they have very different characteristics to the independent directors that form the monitoring board. They

certainly would not be described as "thinly informed", "underresourced" and "boundedly motivated". Indeed, they are quite the opposite. However, it is increasingly common for activist hedge funds to nominate non-affiliated directors to target company boards rather than their own managers. These directors retain many of the characteristics that the independent directors do, but they also likely have more industry expertise, potentially firm-specific knowledge, and perhaps also the support of the resources of the activist hedge fund. The empirical study also addressed whether the short-termism narrative depicting activist hedge funds is accurate for different types of activist campaigns.

Part III then brings all of this analysis together by considering the other important societal issue that was identified in Part I – negative externalities – as well as what activist hedge funds have learned from their board representation campaigns to use in the next iteration of hedge fund activism – ESG activism.

PART III – ESG Activism

Introduction

The passive index investing revolution and the surge in demand for environmental, social, and governance ("ESG") investment products are the most monumental changes to sweep across the investor landscape for many years.[478] The genesis of this unprecedented transformation in investor behavior can be traced back to the demise of the archetypal "Berle-Means corporation."[479] Epitomized by the dichotomy between powerful managers and powerless, dispersed shareholders,[480] the decades-long reconcentration of institutional investor ownership largely displaced the traditional account of the corporation in Anglo-American corporate governance.[481] Particularly in the aftermath of the global financial crisis, there has been an escalating shift from active to passive investment

[478] On the passive index investing revolution, see Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2033 (2019) [hereinafter *Index Funds*] (noting that "the proportion of equities held by index funds has risen dramatically over the past two decades and can be expected to continue growing strongly"); Jill Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17, 19 (2019) (noting that "[p]assive investors . . . are the new power brokers of modern capital markets"); John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* 2 (Harv. Pub. L., Working Paper No. 19-07, 2018), https://ssrn.com/abstract=3247337 (noting that indexing is one of three "ongoing mega-trends" that are "reshaping corporate governance"). On the surge in demand for ESG products, see Attracta Mooney & Patrick Mathurin, *ESG Funds Defy Havoc to Ratchet Huge Inflows*, FIN. TIMES (Feb. 6, 2021), https://www.ft.com/content/8e9f8204-83bf-4217-bc9e-d89396279c5b (noting that 2020 "was the year ESG came of age" and that by the end of 2020, total assets in sustainable funds hit a record of almost $1.7 trillion, up 50% over the year). *See also* Larry Fink, *Letter to CEOs*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 30, 2021), https://corpgov.law.harvard.edu/2021/01/30/letter-to-ceos/ (noting a "tectonic shift" in investor behavior towards sustainable investment options).

[479] *See generally* ADOLF A. BERLE, JR. & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) (observing that the separation of ownership and control can result in powerful managers being unconstrained by powerless shareholders, who are unable to effectively monitor managers). The term "Berle-Means corporation" was popularized by Mark Roe in 1991. *See* Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 11 (1991). Brian Cheffins argues that a public company can be characterized by a separation of ownership and control even if institutional investors own the bulk of the shares. *See* Brian R. Cheffins, *The Rise and Fall (?) of the Berle-Means Corporation*, 42 SEATTLE U. L. REV. 445, 448 (2019).

[480] *See generally* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1996) (describing the political economy of the separation of ownership from control in the U.S.).

[481] *See generally* Black, *supra* note 13(discussing how traditional conceptions of corporate power, based on the assumption of small individual shareholders, have been upset by rise of institutional investors that hold a significant portion of shares); Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997 (1994) (exploring British corporate governance as a possible model for American markets controlled by institutional investors); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991) (examining some of the issues raised by increased ownership by institutional investors).

strategies.[482] This culminated in 2019 with assets under management in passive equity funds in the U.S. officially overtaking the corresponding holdings in active equity funds.[483]

Although the active fund industry remains relatively fragmented, the passive index fund industry is extremely concentrated.[484] Consequently, the change in investor ideology has been accompanied by a massive aggregation of power among the largest asset managers who offer passive index funds at the lowest cost. The "Big Three" asset managers — BlackRock, Vanguard and State Street — are now the largest investors in the vast majority of economically significant companies in the U.S.,[485] and to an increasing extent, worldwide.[486] Although all large companies have a major role to play in mitigating the effects of climate change, a relatively small number of companies have been identified as the key perpetrators of global warming.[487] Largely due to their passive index fund offerings — that mechanically track stock market indices such as the S&P 500 in the U.S. or the FTSE 100 in the U.K. — the Big Three are often the biggest shareholders, and common owners, of these offending companies. This tremendous concentration of ownership means that the Big Three have the potential to wield considerable power over the primary perpetrators of climate change as they control a significant proportion of the shares and thus the votes at those companies. With great power comes great responsibility. Calls for asset managers to exercise greater social and environmental responsibility have led to the Big Three increasingly purporting to assume what I call the role of "sustainable

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[482] *See generally* Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298 (2017) (describing the rise of passive index funds held by the "Big Three"). Passive investing generally involves replicating the performance of a specific stock market index, whereas active investing involves actively trading stocks based on assessments of firm value. *See* discussion *infra* Part I.A.

[483] As of August 31, 2019, passive U.S. equity assets surpassed U.S. equity fund assets by about $25 billion. $4.27 trillion (50.15%) of equity assets (in open-end and exchange-traded funds ("ETFs")) were held in passive funds compared to $4.25 trillion (49.85%) held in active funds. Over the past 10 years, active U.S. equity funds have had $1.3 trillion in outflows and their passive counterparts nearly $1.4 trillion in inflows. *See* MORNINGSTAR RSCH., MORNINGSTAR U.S. FUNDS FLOWS: FED RATE CUT DOESN'T SPUR INFLOWS 1-2, 5 (2019), https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/Fund_Flows_August2019_Final.pdf?.

[484] *See* Coates, *supra* note 478, at 2 (detailing the "Problem of Twelve," where control of most public companies will soon become concentrated in the hands of a dozen or fewer people).

[485] *See* Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721, 732-37 (2019) [hereinafter *The Specter*].

[486] *See* Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 482, at 311.

[487] *See* PAUL GRIFFIN, THE CARBON MAJORS DATABASE: CDP CARBON MAJORS REPORT 2017, at 8 (2017), https://b8f65cb373b1b7b15feb-c70d8ead6ced550b4d987d7c03fcdd1d.ssl.cf3.rackcdn.com/cms/reports/documents/000/002/327/original/Carbon-Majors-Report-2017.pdf?1499691240

capitalists."[488] Namely, because Governments have failed to take swift and effective action in the global effort to combat issues such as climate change, there has been increased pressure not only on companies but also on institutional investors to provide market-driven solutions.[489]

As outlined in Chapter 1, the quintessential agency problem in the traditional Berle-Means corporation arose due to the divergence of interests between managers and shareholders.[490] Gilson and Gordon later developed an "agency capitalism" framework where they theorized a new agency problem that arose from the divergence of interests between institutional investors and ultimate beneficial owners.[491] In Chapter 5 of the thesis, I build upon Gilson and Gordon's agency capitalism framework to put forward a new agency-costs theory of sustainable capitalism that accounts for the major shift to passive index investing and ESG investing. In the new "sustainable capitalism" framework, the Big Three act on behalf of diversified index investors — who can be thought of as a proxy for wider society — and they also represent investors who have explicitly chosen to prioritize social and environmental values by investing in ESG funds.[492]

Potential divergence between the interests of the Big Three and the ultimate index investors or ESG investors gives rise to what I call "the agency costs of sustainable

[488] The concept of sustainable capitalism involves companies and investors mobilizing capital to overcome sustainability challenges. *See infra* Part I.D (discussing the potential role of the Big Three as sustainable capitalists).

[489] Prominent figures including Al Gore have criticized the Big Three and other institutional investors and activists have submitted shareholder proposals to the Big Three to induce them to take sustainability issues more seriously. *See infra* Part I (discussing Al Gore's criticisms of the Big Three and his push for sustainable capitalism).

[490] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308-09 (1976) (discussing the relationship between managers and stockholders as an agency relationship). *See generally* John Armour, Henry Hansmann, Reinier Kraakman & Mariana Pargendler, *supra* note 8, at 2 (discussing the various interests of managers and shareholders).

[491] *See generally* Gilson & Gordon, *Agency Capitalism*, *supra* note 466 (analyzing the new agency problem and the role of activist shareholders as governance intermediators who ultimately reduce agency costs).

[492] The preferences of those who invest in ESG funds can diverge. Some investors may prioritize social and environmental values over financial returns and may be willing to accept lower financial returns in favor of higher levels of social and environmental responsibility. Other investors may believe that ESG funds are a "win-win" proposition (as they have often been marketed) and may value maximizing financial returns as highly or even more highly than environmental and social goals. The extent that investors are willing to trade-off financial returns for social and environmental responsibility may also vary considerably. *See generally* Scott Hirst, Kobi Kastiel & Tamar Kricheli-Katz, *How Much Do Investors Care About Social Responsibility?* (Boston. Univ. School of Law Research Paper No. 4115854, 2021), https://ssrn.com/abstract=4115854.

capitalism."[493] Gilson and Gordon described institutional investors in the agency capitalism framework as "rationally reticent," as they would only respond to proposals submitted by other shareholders, rather than being proactive themselves.[494] In the sustainable capitalism framework — where the Big Three act as agents for passive index investors and ESG investors — I identify a potential dual-problem. The Big Three will most probably remain rationally reticent, especially with regard to firm-specific intervention, as many of the problematic incentives in the agency capitalism framework still persist in the new passive investing and sustainability context. However, I also theorize a second problem that might present itself in the sustainable capitalism framework — the risk of the Big Three exhibiting what I call "rational hypocrisy." As with corporate greenwashing, the Big Three might act in a rationally hypocritical manner, as there may be incentives to claim that they uphold a higher commitment to sustainability than is actually the case.

One major difference between the sustainable capitalism framework and the agency capitalism framework is that intervention on climate issues concerns systematic as well as idiosyncratic (firm-specific) risk.[495] Environmental issues represent a portfolio-wide or market-wide problem in contrast to the firm-specific risks that received attention in the agency capitalism framework. Mirroring some of the successful interventions by the Big Three in portfolio-wide governance issues (such as board gender diversity),[496] there may be some promise for the Big Three in their assumed role as sustainable capitalists.

A parallel can be drawn between the sustainable capitalist framework and the agency capitalism framework, as a monitoring shortfall persists. The solution that was identified by Gilson and Gordon to reduce the agency costs of agency capitalism was for activist hedge funds to fill the monitoring shortfall left by institutional investors. Such activists were described as playing the role of governance intermediaries or arbitrageurs.[497]

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[493] *See infra* Part II (discussing the agency costs of sustainable capitalism).
[494] Gilson & Gordon, *Agency Capitalism*, *supra* note 466, at 889, 895.
[495] *See* John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35, 36 (2014) (noting that "the portfolios of diversified shareholders are insulated from the effects of idiosyncratic (firm-specific) risks"). *See generally* Jeffrey Gordon, *Systematic Stewardship* (Eur. Corp. Governance Inst., Law Working Paper No. 566/2021, 2021), http://ssrn.com/abstract_id=3782814.
[496] *See* Michal Barzuza, Quinn Curtis & David H. Webber, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV. 1243, 1265-69 (2020).
[497] *See* Gilson & Gordon, *Agency Capitalism*, *supra* note 466, at 896-902.

Similarly, in the realm of sustainable capitalism, a vocal minority of activist hedge funds have already transitioned to focus on ESG activism.[498]

In the agency capitalism framework, the combination of activist shareholders as initiators and institutional investors as arbiters proved to be a successful means of mitigating the agency costs of agency capitalism.[499] This may have been due to a general complementarity of the interests and incentives of activist hedge funds and the institutional investors who are pivotal in supporting their campaigns. Put simply, if the activist hedge fund intervention were successful, both the activist's position and the institutional investor's position would increase in value. Both sets of shareholders ultimately sought to increase shareholder value. As discussed in Part II of this thesis, there was some level of conflict inherent in whether the appropriate focus was on short-term or long-term shareholder wealth maximization.[500] However, over time, these conflicts in time horizons were resolved to some extent. My empirical study on activist board representation has shown that activist hedge funds' tactics evolved to incorporate a longer-term perspective, potentially to appease the institutional investors who provided crucial support to their campaigns.[501]

In the sustainable capitalism framework, I argue that ESG hedge funds may fulfil a role that no other actor is well positioned to fill. As we have seen in the agency capitalism framework, activist hedge funds are specialists in *firm-specific* intervention. Although the Big Three should rationally be more concerned with *portfolio-wide* risk in the context of climate change,[502] they could still be expected to support firm-specific sustainability initiatives advancing that goal. Therefore, ESG hedge funds could successfully mitigate the problem of rational reticence with respect to firm-specific sustainability activism.

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[498] *See infra* Chapter 6, II.C and II (discussing ESG activism on the part of hedge funds).
[499] Gilson & Gordon, *Agency Capitalism*, *supra* note 466, at 897-98.
[500] BlackRock, Vanguard, and State Street all issued statements supporting long-term investment and criticizing financial engineering that creates short-term profits at the expense of sustainable value. Martin Lipton, *Some Thoughts for Boards of Directors in 2017*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 8, 2016), https://corpgov.law.harvard.edu/2016/12/08/some-thoughts-for-boards-of-directors-in-2017.
[501] *See supra* Part II, Chapters 3 and 4 (discussing activist board representation).
[502] *See infra* Section II.A.1 (discussing climate risk as systematic portfolio-risk).

Building upon the evidence presented in Chapter 4, and the problems identified in Chapter 5, I argue in Chapter 6 that the most valuable contribution that ESG hedge funds may make to mitigate the agency costs of sustainable capitalism is to nominate specialist directors — for example those with renewable energy or climate transition expertise — to corporate boards.[503] The Big Three, in their assumed role as sustainable capitalists, can then lend their support to credible alternative board nominees. ESG hedge funds are well positioned to play this unique role, as activist hedge funds already have significant expertise in executing successful board representation campaigns over the past decade.[504] The Big Three have also shown enthusiastic willingness to support board changes, for example in board gender diversity.[505]

Other intermediaries are also, however, candidates for the role of "ESG arbitrageurs."[506] Chapter 7 highlights that a range of different "socially responsible activists" already submit ESG-related shareholder proposals to large corporations.[507] It also discusses whether ESG hedge funds will likely only pursue ESG strategies that will contribute to the "double bottom-line" of generating a significant profit as well as being environmentally or socially beneficial. Focusing more on portfolio-wide ESG issues, responsible activist organizations ordinarily have different incentives to activist hedge funds, as their primary focus will usually be mitigating climate or other sustainability risks. However, there are clear limitations to this approach, as the shareholder proposal mechanism is a notoriously slow means of effecting change and such investors may also lack the reputation, clout,

[503] *See infra* Chapter 6, Section II.B (discussing the potential for ESG hedge funds to nominate climate directors to corporate boards).
[504] *See supra* Chapters 3 and 4 (discussing activist hedge fund board representation).
[505] *See* Barzuza et al., *supra* note 496, at 1265-69. *See generally* Todd A. Gormley, Vishal K. Gupta, David A. Matsa, Sandra C. Mortal & Lukai Yang, *The Big Three and Board Gender Diversity: The Effectiveness of Shareholder Voice* (Eur. Corp. Governance Inst. Fin., Working Paper No. 714/2020, 2021), https://ssrn.com/abstract=3724653 (discussing the success of Big Three campaigns to increase gender diversity on corporate boards).
[506] In the agency capitalism framework, Gilson and Gordon outlined that the rational reticence of institutional investors left a governance gap or shortfall in the monitoring of managerial agency costs. Specialist activist hedge funds could then act as "governance arbitrageurs" by taking advantage of the arbitrage opportunity created by the existence of the governance gap. *See* Gilson & Gordon, *Agency Capitalism*, *supra* note 466, at 896. Similarly, in the sustainable capitalism framework, the rational reticence of the Big Three and other asset managers leaves a gap or shortfall in terms of ESG activism. Thus, there is a parallel ESG arbitrage opportunity which a number of actors may be well positioned to fill as "ESG arbitrageurs."
[507] *See infra* Chapter 7, Section II. (discussing ESG shareholder proposals).

expertise,[508] and funding that the most formidable hedge funds have amassed in order to effectively challenge some of the world's most economically significant corporations. Ultimately, it may be that one of the most important roles that these socially responsible activists can play in the investor ecosystem is by addressing any rational hypocrisy, including by targeting the Big Three and other large asset managers themselves.

This Part proceeds as follows. In Chapter 5, Section I introduces the concept of sustainable capitalism. It discusses how the momentous growth of passive index investing has resulted in a significant concentration of power among the largest asset managers, specifically the "Big Three." It also considers how the Big Three have assumed the role of "sustainable capitalists," given that they are now the largest common owners of the vast majority of globally significant corporations. Section II focuses on the agency costs of sustainable capitalism. It introduces the dual problem that presents itself in the sustainability context, namely, the persistence of "rational reticence" (particularly with regard to firm-specific sustainability activism) and the risk of "rational hypocrisy."

Chapter 6 links the evolution of the original governance arbitrageurs identified in Gilson and Gordon's agency capitalism framework — activist hedge funds — to the new ESG agenda. Section I reiterates how such activists have evolved and adapted their strategies over time, as explained empirically in Chapter 4. These developments have occurred alongside a strengthening in power of the long-term institutional investors who are the ultimate arbiters of activist hedge fund campaigns. Chapter 6 also discusses hedge funds' recent foray into ESG activism and delves more deeply into the role of ESG hedge funds as the new ESG arbitrageurs in the sustainable capitalism framework. It demonstrates how well positioned ESG hedge funds are to nominate climate directors to corporate boards, a tactic that should attract the support of the Big Three. Finally, it highlights some of the ESG campaigns from the last few years that can help to shed some light on how ESG activist hedge fund campaigns by major hedge funds and specialist ESG funds might fit into the ESG investment landscape.

[508] *See generally* C.N.V. Krishnan, Frank Partnoy & Randall S. Thomas, *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise*, 40 J. CORP. FIN. 296 (2016) (discussing how top activist hedge funds have succeeded in part due to establishing a reputation for "clout and expertise").

Chapter 7 considers the tradeoffs between purpose and profit in ESG activism. The role of other socially responsible activists in the sustainable capitalism framework is also highlighted. It explains the limitations of the shareholder proposal mechanism to effect strategic or board-level change and ultimately concludes that socially responsible activists may be ideally placed to hold the Big Three accountable and address rational hypocrisy.

Chapter 5 – The Agency Costs of Sustainable Capitalism

I. SUSTAINABLE CAPITALISM AND THE BIG THREE

At the World Economic Forum in Davos in January 2020, Larry Fink — the chief executive of the world's largest asset manager, BlackRock Inc — wore a scarf themed around climate change data.[509] The scarf was designed by the 2 Degrees Investing Initiative and featured the "warming stripes"[510] visual created by U.K. climate scientist Ed Hawkins, where the color of the stripes represents the annual average temperatures of planet earth from 1850 to 2019.[511] Fink was being interviewed about his 2020 letter to CEOs, which focused on climate risk and ESG investing. In January 2020, BlackRock also signed up to join Climate Action 100+,[512] a global investor-led initiative (with its members now managing over $35 trillion in assets) which aims to ensure that the world's largest corporate greenhouse gas emitters take necessary action on climate change.[513] These bold announcements followed a period of intense pressure directed at BlackRock and other large asset managers, which urged them to take responsibility for their role in the climate crisis. Only a few weeks earlier, a coalition of shareholders had filed resolutions at BlackRock and Vanguard calling for the asset managers to review their voting policies on climate change issues, given their consistent record for voting against climate-oriented proposals.[514] Other prominent figures, including former U.S. vice president Al Gore, similarly criticized BlackRock and Vanguard, accusing them of financing "the destruction

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[509] Emily Chasan, *Even Larry Fink's Davos Scarf Is All About Climate Change*, BLOOMBERG L. (Jan. 23, 2020), https://www.bloomberg.com/news/articles/2020-01-23/even-larry-fink-s-davos-scarf-is-all-about-climate-change.

[510] Chasan, *supra* note 509; Ed Hawkins, *Warming Stripes for GLOBE from 1850-2020* (image), #SHOWYOURSTRIPES, https://showyourstripes.info.

[511] Chasan, *supra* note 509.

[512] CLIMATE ACTION 100+, https://www.climateaction100.org. BlackRock (and Vanguard) had voted against all of the U.S. shareholder proposals backed by Climate 100+ until September 2019. *See* MAJORITY ACTION, CLIMATE IN THE BOARDROOM: HOW ASSET MANAGER VOTING SHAPED CORPORATE CLIMATE ACTION IN 2019, at 4 (2019), https://static1.squarespace.com/static/5d4df99c531b6d0001b48264/t/5d8006692e5b035cf0d2b17f/1568674165939/assetmanagerreport2019.pdf [hereinafter 2019 CORPORATE CLIMATE ACTION].

[513] Richard Henderson, *BlackRock Joins Climate Action Group After 'Greenwash' Criticism*, FIN. TIMES (Jan. 9, 2020), https://www.ft.com/content/16125442-32b4-11ea-a329-0bcf87a328f2.

[514] Mercy Investment Services (the investment program of the Sisters of Mercy of the Americas, a group of Catholic nuns) filed the resolution ahead of BlackRock's annual meeting, stating that BlackRock only supported six of fifty-two climate-related resolutions in 2019. *See* Attracta Mooney, *Nuns Take on BlackRock over Climate Change*, FIN. TIMES (Dec. 14, 2019), https://www.ft.com/content/9f84e865-31ad-4a13-9398-8781e2cb0581.

of human civilization."[515] Even activist hedge fund managers were vocal in their criticism. In December 2019, Christopher Hohn of TCI accused the asset manager of being "full of greenwash."[516] Thus in early 2020, BlackRock strengthened its commitment to "sustainability and climate-integrated portfolios," vowing to use its significant power as the world's largest asset manager as a force for good.[517]

A. The Passive Index Investing Revolution

How did asset managers such as BlackRock, Vanguard and State Street amass such power? Much of their dominance is a by-product of the passive index investing revolution. In 1975, John Bogle and the Vanguard Group created the first index mutual fund for ordinary investors, named the First Index Investment Trust.[518] On inception, this index fund (nicknamed "Bogle's folly" after its creator) was denounced as "un-American" and "a sure path to mediocrity",[519] with additional claims that "indexing is likely to be an idea whose

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[515] Gillian Tett, Billy Nauman, Patrick Temple-West, Leslie Hook, Mehreen Khan, Anna Gross, Tamami Shimizuishi & Andrew Edgecliffe-Johnson, *Moral Money: Al Gore Blasts BlackRock, Brussels Breakdown, Rewild the UK*, FIN. TIMES (Dec. 11, 2019), https://www.ft.com/content/92c728e6-1ba3-11ea-97df-cc63de1d73f4.

[516] Leslie Hook & Gillian Tett, *Hedge Fund TCI Vows to Punish Directors over Climate Change*, FIN. TIMES (Dec. 1, 2019), https://www.ft.com/content/dde5e4d4-140f-11ea-9ee4-11f260415385.

[517] Letter from Larry Fink, Chairman and Chief Exec. Officer, BlackRock, to CEO, https://www.blackrock.com/uk/intermediaries/larry-fink-ceo-letter [hereinafter 2020 Letter from Larry Fink]. Since then, BlackRock have backtracked somewhat on their public commitments to sustainability. For example, BlackRock announced in May 2022 that they expected to back fewer shareholder resolutions on issues such as climate change in 2022 as they believed that many of the proposals were too prescriptive. *See* Simon Jessop, *BlackRock to back fewer shareholder resolutions in this AGM season*, REUTERS (May 10, 2022), https://www.reuters.com/business/blackrock-back-fewer-shareholder-resolutions-this-agm-season-2022-05-10/. In an interview in June 2022, Larry Fink went further and said that "I don't want to be the environmental police". *See* Silla Brush & Annie Massa, *Fink Says BlackRock Doesn't Want to Be 'Environmental Police'*, BLOOMBERG (June 2, 2022), https://www.bloomberg.com/news/articles/2022-06-02/fink-says-blackrock-doesn-t-want-to-be-environmental-police?leadSource=uverify%20wall.

[518] The fund is now the Vanguard 500 Index Fund. Bogle claimed that the inspiration for the idea of the index fund came in 1951 from his Princeton University senior thesis where he noted that mutual funds "could make no claim to superiority over the market averages." John C. Bogle, *The Index Mutual Fund: 40 Years of Growth, Change, and Challenge*, 72 FIN. ANALYSTS J. 9, 9 (2016). However, it has been noted by Robin Wigglesworth that this "simply isn't credible". ROBIN WIGGLESWORTH, TRILLIONS: HOW A BAND OF WALL STREET RENEGADES INVENTED THE INDEX FUND AND CHANGED FINANCE FOR EVER 107 (2021). The book also discusses earlier index funds created by Wells Fargo and Batterymarch that were "solely the preserve of big institutional investors" (at 84). The creation of the Vanguard fund in 1975 also followed the recent publication of two influential finance works that supported indexing as an investment strategy: BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET: THE TIME TESTED STRATEGY FOR SUCCESSFUL INVESTING (1973) and Paul A. Samuelson, *Challenge to Judgment*, 1 J. PORTFOLIO MGMT. 17 (1974).

[519] Tanza Loudenback, *When Vanguard's Founder First Invented the Index Fund, It Was Ridiculed as 'Un-American,' but 40 Years Later It's Clear His Critics Were Wrong*, BUS. INSIDER (Jan. 18, 2019), https://www.businessinsider.com/vanguard-jack-bogle-first-index-fund-criticism-2019-1?r=US&IR=T.

time will pass".[520] It took two full decades before index funds began to earn broad acceptance in the mid-1990s.[521]

Index funds are a type of investment fund that pools the assets of multiple investors to invest in a diversified portfolio of securities.[522] The funds replicate the performance of a specific benchmark stock market index (such as the S&P 500 index in the U.S. or the FTSE 100 index in the U.K.) or track a specially designed bespoke index.[523] This passive investment approach can be contrasted with the "stock picking" strategy utilized by actively managed investment funds, where shares are actively traded based upon fund managers' firm-specific analysis which aims to uncover whether companies are undervalued or overvalued.[524] Passive index funds can take the form of traditional mutual funds, exchange traded funds ("ETFs"),[525] or any other investment vehicle that algorithmically tracks a pre-defined index.[526] This can include bespoke ESG index funds.

The principle of indexation is grounded in Modern Portfolio Theory[527] and reflects the ideology that few investors can reliably and consistently "beat the market" with a more active stock picking strategy.[528] Empirical studies comparing the performance of active and passive funds reveal that the majority of active funds have not been able to generate higher returns compared with benchmark indices such as the S&P 500.[529] As a result, diversifying an investor's portfolio to hold virtually the entire stock market for the long-term is

[520] Wigglesworth, *supra* note 40, at 84 (citing *Institutional Investor,* June 1977).
[521] Bogle, *supra* note 518, at 9.
[522] *See* Bebchuk & Hirst, *Index Funds*, *supra* note 478, at 2043-44; Fisch et al., *supra* note 478, at 22.
[523] Jan Fichtner & Eelke M. Heemskerk, *The New Permanent Universal Owners: Index Funds, Patient Capital, and the Distinction Between Feeble and Forceful Stewardship*, 49 ECON. & SOC'Y 493, 494 (2020); *see* Fisch et al., *supra* note 478, at 21 (citing Adriana Z. Robertson, *Passive in Name Only: Delegated Management and "Index" Investing*, 36 YALE J. ON REGUL. 795, 821 (2019) (explaining the nature of bespoke indices)).
[524] *See* Bechuk & Hirst, *Index Funds, supra* note 478, at 2043-44.
[525] Index funds are traded only once a day after markets have closed whereas ETFs can be bought and sold continuously during the entire trading day. *See* Benjamin Braun, *From Performativity to Political Economy: Index Investing, ETFs and Asset Manager Capitalism*, 21 NEW POL. ECON. 257, 266 (2016).
[526] *See* Bebchuk & Hirst, *Index Funds*, *supra* note 478, at 2044 (citing LOIS YUROW, TIMOTHY W. LEVIN, JOHN W. MCGUIRE & JAMES M. STOREY, MUTUAL FUNDS REGULATION AND COMPLIANCE HANDBOOK § 4:1 (2017) and William A. Birdthistle, *The Fortunes and Foibles of Exchange-Traded Funds: A Positive Market Response to the Problems of Mutual Funds*, 33 DEL. J. CORP. L. 69, 76-86 (2008) (noting rules governing mutual funds and ETFs)).
[527] Modern Portfolio Theory is based on economist Harry Markowitz's theory which outlines that investors can maximize their return and reduce idiosyncratic (firm-specific) risk by diversifying their assets using a quantitative method. *See* Harry Markowitz, *Portfolio Selection*, 7 J. FINANCE. 77, 77 (1952).
[528] Coates, *supra* note 478, at 5.
[529] Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 506 (2018).

generally thought to earn the highest risk-adjusted return. This is particularly the case after the deduction of investment costs such as advisory fees, as indexation minimizes portfolio turnover and thus operating costs.[530] Index funds are advantageous to ultimate investors for a multitude of reasons, including reduced risk through diversification and very low, or even non-existent,[531] management fees.

The "momentous rise" of passive index funds has been described as a "pivotal shift" in capital migration from active to passive asset management.[532] In August 2019 it was reported that passive equity funds in the U.S. had officially overtaken active equity funds in terms of assets under management.[533] One newspaper report went so far as to proclaim that index funds are "eating the world."[534] This dramatic shift in investor behavior became particularly pronounced in the years following the 2008 financial crisis, when both individual and institutional investors "massively shifted capital from expensive, actively managed mutual funds to cheap, index mutual funds and exchange traded funds."[535] At the beginning of 2010, there was about $2.3 trillion in index funds whereas at the end of 2019, the global passive index investing market was worth $11.4 trillion.[536] The gravitation towards index funds has been driven by growing recognition of their low costs and tax benefits, together with increasing evidence that they outperform the majority of actively managed equity mutual funds.[537] For these reasons, index funds at least "seem to be a rare case of financial innovation that actually helps regular people" and have been described as "a populist victory, as finance goes."[538]

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[530] *See* Bogle, *supra* note 518, at 9.

[531] In late 2018, Fidelity announced a series of zero-fee investment products, while also dropping the charges on all its index funds to historic lows and removing minimum capital requirements. *See* Owen Walker, *Fidelity's Zero-Fee Campaign Spurs $6.6bn of Inflows*, FIN. TIMES (Nov. 26, 2018), https://www.ft.com/content/d8569037-98fa-35bd-b3e5-861e8168161d.

[532] *E.g.*, Fichtner et al., *supra* note 482, at 300.

[533] *See* MORNINGSTAR RSCH., *supra* note 483, at 2.

[534] Jason Zweig, *Are Index Funds Eating the World?*, WALL ST. J.: MONEYBEAT BLOG (Aug. 26, 2016), https://blogs.wsj.com/moneybeat/2016/08/26/are-index-funds-eating-the-world.

[535] Fichtner et al., *supra* note 482, at 298-99.

[536] Robin Wigglesworth & Alex Janiaud, *Index Funds Break Through $10tn-in-Assets Mark*, FIN. TIMES (Jan. 8, 2020), https://www.ft.com/content/a7e20d96-318c-11ea-9703-eea0cae3f0de (citing MORNINGSTAR RSCH., *supra* note 483).

[537] Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPS. 89, 94 (2017) (citing Kenneth R. French, *Presidential Address: The Cost of Active Investing*, 63 J. FIN. 1537 (2008)).

[538] Frank Partnoy, *Are Index Funds Evil?*, ATLANTIC (Sept. 2017), https://www.theatlantic.com/magazine/archive/2017/09/are-index-funds-evil/534183/.

The transition from active to passive investing is likewise taking place in the U.K. and Europe, although the ascendancy of index investing is generally less pronounced than in the U.S., where the concept was pioneered. In the U.K., around 26% of assets are held in passive index funds.[539] In Europe, passive index funds make up around 20% of the assets under management, with individual European countries varying significantly (e.g., Switzerland 58.7%, Germany 11.1%, and Italy 0.05%).[540] Although the rise of passive investing in Europe is less dramatic than the U.S., it has nevertheless experienced significant growth in the past decade.[541]

B. Concentration of Asset Managers — The Big Three

The fundamental shift in investor ideology described above has led to a significant aggregation of power among the largest asset managers who offer passive index funds at the lowest cost.[542] Although the active fund management industry is relatively fragmented, the index fund industry is extremely concentrated. The "Big Three" asset managers are now the largest investors in the vast majority of economically significant companies. Collectively, they have global assets under management of over $22 trillion, with BlackRock's portfolio amounting to over $10 trillion,[543] Vanguard's over $8 trillion,[544] and State Street's more than $4 trillion.[545] To put that into perspective, the GDP of the world's

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[539] Steve Johnson, *Passive Funds' Share of European Investment Market Jumps to 20%*, FIN. TIMES (Dec. 7, 2020), https://www.ft.com/content/0b5325da-585f-41ad-8267-0741e9693a7a.

[540] *Id.*

[541] *See* Giovanni Strampelli, *Are Passive Index Funds Active Owners? Corporate Governance Consequences of Passive Investing*, 55 SAN DIEGO L. REV. 803, 811-12 (2018) (outlining that this growth is expected to continue given regulatory changes in EU financial markets).

[542] *See* Bebchuk & Hirst, *Index Funds*, *supra* note 478, at 2044; Bebchuk & Hirst, *The Specter*, *supra* note 485, at 729-31.

[543] Robin Wigglesworth and Harriet Agnew, *BlackRock surges past $10tn in assets under management*, FIN. TIMES (Jan. 14, 2022) https://www.ft.com/content/7603e676-779b-4c13-8f46-a964594e3c2f (noting that BlackRock's assets grew 15% in the fourth quarter of 2021 to reach $10.01tn).

[544] Global assets under management were $8.2 trillion as of November 30, 2021. *Vanguard to Expand ESG Lineup with Positive Impact Stock Fund*, VANGUARD, https://corporate.vanguard.com/content/corporatesite/us/en/corp/who-we-are/pressroom/Press-Release-VG-to-Expand-ESG-Lineup-with-Positive-Impact-Stock-Fund-011922.html.

[545] Global assets under management were $4.1 trillion as of December 31, 2021. *See* Press Release, State St., State St. Reports Fourth-Quarter and Full-Year 2021 Financial Results (Jan. 19, 2022), https://newsroom.statestreet.com/press-releases/press-release-details/2022/State-Street-Reports-Fourth-Quarter-and-Full-Year-2021-Financial-Results/default.aspx.

largest three economies is $23 trillion[546] for the U.S., $17.73 trillion for China,[547] and $5.06 trillion for Japan.[548] The Big Three's concentration of power is also accelerating rapidly. From 2016 to 2022, their assets under management grew by almost 200%.[549] There is unlikely to be a serious challenge to the market power of the Big Three, which led Bebchuk and Hirst to predict that "the Big Three will likely continue to grow into a 'Giant Three.'"[550] One of the main reasons for this continuing concentration of asset managers is that passive index investing is a business of scale[551] and the Big Three have the benefit of first-mover advantage. They now dominate the market, managing over 90% of all assets under management in passive equity funds.[552] Therefore, they occupy a "quasi-monopolistic"[553] position and form an "oligopoly."[554] It would be extremely difficult for new entrants or even large pre-existing asset managers to make meaningful inroads into that level of market power.

Due to their passive index fund holdings, the Big Three are now permanent shareholders in the majority of companies globally. In the U.S., they control more than 20% of the shares of the average S&P 500 company, which translates into more than 25% of shares voted in such companies.[555] After the U.S., the U.K. is the jurisdiction with the next most

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[546] *GDP (Current US$) - United States*, THE WORLD BANK, https://data.worldbank.org/country/US (last visited Aug. 1, 2022).
[547] *GDP (Current US$) - China*, THE WORLD BANK, https://data.worldbank.org/country/CN (last visited Aug. 1, 2022).
[548] *GDP (Current US$) - Japan*, THE WORLD BANK, https://data.worldbank.org/country/JP (last visited Aug. 1, 2022).
[549] *See* Bebchuk et al., *supra* note 537, at 94 (noting that BlackRock, Vanguard and State Street Global Advisors had assets under management of $3.1 trillion, $2.5 trillion and $1.9 trillion, respectively, in 2016).
[550] Bebchuk & Hirst, *The Specter*, *supra* note 485, at 723.
[551] *See generally* Patrick Jahnke, *Ownership Concentration and Institutional Investors' Governance Through Voice and Exit*, 21 BUS. & POL. 327 (2019) (discussing the relationship between increased concentration of assets and economies of scale).
[552] *See* Fichtner et al., *supra* note 482, at 304.
[553] Jan Fichtner, Eelke Heemskerk & Javier Garcia-Bernardo, *These Three Firms Own Corporate America*, CONVERSATION (May 10, 2017), https://theconversation.com/these-three-firms-own-corporate-america-77072.
[554] Julie Segal, *There's an Oligopoly in Asset Management. This Researcher Says It Should Be Broken Up*, INST. INV. (Nov. 24, 2020), https://www.institutionalinvestor.com/article/b1pcwthdczlycw/There-s-an-Oligopoly-in-Asset-Management-This-Researcher-Says-It-Should-Be-Broken-Up.
[555] Bebchuk & Hirst, *The Specter*, *supra* note 485, at 724 (stressing that because the Big Three generally vote all of their shares, whereas not all of the non-Big Three shareholders do so, the shares held by the Big Three translate into even greater voting power); *see also* José Azar, Miguel Duro, Igor Kadach & Gaizka Ormazabal, *The Big Three and Corporate Carbon Emissions Around the World*, 20 (Eur. Corp. Governance Inst., Finance Working Paper No. 715/2000, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3553258 (noting that this measure of Big Three ownership is a lower bound estimate of the total amount of claims owned directly or indirectly by these institutions).

significant blockholdings held by the Big Three, amounting to more than 10% of the shares of the average FTSE 100 company.[556] Therefore, unlike the traditional Berle-Means corporation which was characterized by strong managers and weak owners,[557] the Big Three are in principle extremely strong shareholders of the member firms of the major U.S. and U.K. stock market indices. Even before the exponential rise of passive index investing as an investment strategy, Gilson and Kraakman opined that "we lack a normative model for how shareholders who invest 'in the market' should behave towards the companies in which they invest."[558] This is particularly important in the current climate crisis, as discussed in Section C below.

C. Who Fuels the Fossil Fuel Industry?

Since 1988,[559] it is estimated that over half of global emissions have been caused by only twenty-five corporate and state entities (a list that includes U.S. companies ExxonMobil, Chevron and ConocoPhillips and U.K. companies Shell and BP).[560] Therefore, a relatively small number of companies have been identified as the key corporate perpetrators of global warming. Each of the U.S. and U.K. companies identified on the list of the key twenty-five perpetrators is either a constituent of the U.S. S&P 500 index or the U.K. FTSE 100 index.[561]

In recent years, pressure on university endowments, pension funds and other institutions to divest from fossil fuel companies has intensified. Divestment campaigns and protests are increasingly successful and large numbers of funds continue to actively divest (or

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[556] *See* Fichtner & Heemskerk, *supra* note 523, at 502; *see also* Suren Gomtsian, *Voting Engagement by Large Institutional Investors*, 45 J. CORP. L. 659, 671-72 (2020) (noting that in 2017 BlackRock and Vanguard were among the top ten shareholders in 90% of FTSE 100 companies with average shareholdings of 6.49% and 2.09%, respectively, and noting that BlackRock was the largest shareholder in almost half of those companies, sometimes with shareholdings above 10%).

[557] *See* ROE, *supra* note 480, at 6-7.

[558] Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 864 (1991).

[559] The year the Intergovernmental Panel on Climate Change was established.

[560] *See* Griffin, *supra* note 487, at 8.

[561] The relevant U.S. companies are ExxonMobil, Chevron, and ConocoPhillips (all constituents of the S&P 500 index) and the relevant U.K. companies are Shell and BP (both constituents of the FTSE 100 index). *See id.*

commit to divest) from fossil fuels.[562] Given the continuing mass exodus of actively managed portfolios from fossil fuel investments, and the continued rise of passive index funds that track the major stock market indices, the biggest shareholders of the prominent fossil fuel companies are now passive index funds. In terms of fossil fuel investments, index funds are becoming "the holders of last resort".[563] To illustrate, Table 10 shows that the Big Three collectively manage more than 20% of the stock of all eight oil and gas exploration and production companies in the S&P 500.

Table 10: Percentage of Stock in Eight Largest U.S. Oil and Gas Exploration and Production Companies held by the Big Three[564]

Corporation (by market value)	*Percentage of Stock Held*			
	BlackRock	*Vanguard*	*State Street*	*Big Three collectively*
ExxonMobil Corp	6.53%	8.65%	5.96%	21.14%
Chevron Corp	6.49%	8.54%	7.02%	22.05%
ConocoPhillips	8.31%	8.59%	5.10%	22.00%
Marathon Petroleum Corp	9.32%	10.80%	7.72%	27.84%
Occidental Petroleum Corp	6.47%	10.87%	6.20%	23.54%
Hess Corp	8.41%	9.94%	6.15%	24.50%
Devon Energy Corp	8.33%	11.42%	6.35%	26.10%
APA Corp	7.00%	12.87%	6.81%	26.68%

[562] To date, it is estimated that over 1,500 institutions have either divested or committed to divest approximately $39.88 trillion from fossil fuels. *See* GLOB. FOSSIL FUEL DIVESTMENT COMMITMENTS DATABASE, https://divestmentdatabase.org/.

[563] *See generally* Patrick Jahnke, *Holders of Last Resort: The Role of Index Funds and Index Providers in Divestment and Climate Change* (Mar. 9, 2019) (unpublished manuscript) (available at https://ssrn.com/abstract=3314906 (discussing how index funds are among the last holders of fossil fuel investments and providing possible ways for them to reduce the "carbon intensity" of their holdings).

[564] Ownership data as of Mar. 31, 2022, extracted from Fidelity Stock Research Center. *Stock Research Center*, FIDELITY, https://eresearch.fidelity.com/eresearch/landing.jhtml.

These holdings are largely comprised of passive index funds. It was reported in 2019 that 98.2% of Vanguard's fossil fuel investments are held in passive funds, with the corresponding figures for BlackRock and State Street being 88.7% and 99%, respectively.[565]

Climate Action 100+ also keeps an up-to-date list of "focus companies" that are key to driving the global net-zero emissions transition. At present, they have selected 167 focus companies for engagement, which account for over 80% of corporate industrial greenhouse gas emissions.[566] Of the nine U.K. companies on this list, eight are in the FTSE 100 index and one is in the FTSE 250 index. Of the forty-five U.S. companies on the list, forty-three are in the S&P 500 index.[567] All of these "focus companies" will have a high percentage of shares owned by the Big Three in passive index funds. In addition to a focus on the companies that directly contribute to climate change through their operations, there has also been a more recent movement (particularly by non-governmental organizations) to target the financiers of the fossil fuel industry — large commercial banks.[568] Again, the major shareholders of these banks will include the Big Three. This underscores the role of the Big Three as the primary agents who are most invested in the major companies fueling the climate crisis.

D. The Big Three as Sustainable Capitalists?

Due to increased scrutiny of their role in the climate crisis, the Big Three have appeared to assume what I call the role of "sustainable capitalists." The concept of "sustainable capitalism" was advanced in a manifesto by Al Gore and David Blood in 2011 as "a framework that seeks to maximize long-term economic value by reforming markets to address real needs while integrating environmental, social, and governance (ESG)

[565] Patrick Greenfield, *World's Top Three Asset Managers Oversee $300bn Fossil Fuel Investments*, GUARDIAN (Oct. 12, 2019), https://www.theguardian.com/environment/2019/oct/12/top-three-asset-managers-fossil-fuel-investments.
[566] *Companies*, CLIMATE ACTION 100+, https://www.climateaction100.org/whos-involved/companies/.
[567] The only two focus companies not in the S&P 500 are Bunge Limited and Vistra Energy.
[568] One notable campaign is "Fossil Banks No Thanks." FOSSIL BANKS NO THANKS, https://www.fossilbanks.org.

metrics."[569] In particular, Gore and Blood stressed that "businesses cannot be asked to do the job of governments, but companies and investors will ultimately mobilize most of the capital needed to overcome the unprecedented challenges we now face."[570] In the last few years, the Big Three have begun to release public statements echoing these sentiments. Larry Fink's 2020 letter to CEOs advocated "achieving a more sustainable and inclusive capitalism," noting that "while government must lead the way in this transition, companies and investors also have a meaningful role to play."[571] Moreover, State Street outlined the "important role" institutional investors have to play in sustainable capitalism, stating that "capitalism works best when there is a healthy balance of power across the state, the market and civil society."[572]

The global problem of the climate crisis should, most appropriately, be addressed by democratically elected national governments and international cooperation, by way of environmental regulation and international treaties.[573] It has also long been recognized by corporate law scholars that "the most efficacious legal mechanisms for protecting the interests of non-shareholder constituencies . . . lie outside of corporate law . . . . For the public at large, it includes environmental law and the law of nuisance and mass torts."[574] As noted by Armour and Gordon, "the consensus view is that the appropriate techniques for controlling externalities are themselves *external* to firms: that is they do not involve any modification to internal corporate governance commitments."[575] However, as Davies highlights, "faith in both these extra-corporate legal mechanisms seems to have waned over the past decade."[576] Much like "the ability of external mechanisms to impound social costs in systematically important financial firms' profit functions," regulation dealing with

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[569] Al Gore & David Blood, *A Manifesto for Sustainable Capitalism: How Businesses Can Embrace Environmental, Social and Governance Metrics*, WALL ST. J. (Dec. 14, 2011), https://www.wsj.com/articles/SB10001424052970203430404577092682864215896.

[570] *Id.*

[571] 2020 Letter from Larry Fink, *supra* note 517.

[572] *Milken Institute 2020 Global Conference, The Future of Capitalism: A Panel Discussion with Ron O'Hanley*, STATE ST. (Oct. 2020), https://www.statestreet.com/ideas/articles/ohanley-future-of-capitalism-milken.html.

[573] As climate change is a global emergency that goes beyond national borders, it requires international cooperation and coordinated solutions. *See The Paris Agreement,* UNITED NATIONS, https://www.un.org/en/climatechange/paris-agreement (explaining the United Nation's Paris Agreement, signed in 2015).

[574] Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 442 (2001).

[575] Armour & Gordon, *supra* note 495, at 44.

[576] PAUL DAVIES, INTRODUCTION TO COMPANY LAW 340 (3d ed. 2020).

the problem of climate change has similarly turned out to be "highly incomplete."[577] The climate campaigner Greta Thunberg has pointed out that "political leaders have wasted decades through denial and inaction"[578] and even in 2022 — a time when the urgency of the climate crisis is much more universally accepted and is increasingly visible through extreme weather patterns and the resulting devastation — government action still remains woefully inadequate. This may justify a mandate for investor intervention. In this vein, Hart and Zingales argue that "if political change is hard to achieve, action at the corporate level is a reasonable substitute."[579] Similarly, Azar, Duro, Kadach and Ormazaball stress that "since a full-scale regulatory solution to the emissions externality problem faces severe coordination frictions across countries, corporate governance is regarded as an alternative way of addressing climate change."[580]

The Big Three themselves, together with other investors, have criticized the failure of governments to adequately address the climate crisis. In 2018, Larry Fink stated that "we see many governments failing to prepare for the future," so it falls to the private sector to "respond to broader societal challenges."[581] He also reiterated a similar message in 2019, noting that due to the "failure of government to provide lasting solutions, society is increasingly looking to companies, both public and private, to address pressing social and economic issues."[582] Further, Christopher Hohn of the activist hedge fund TCI argued in December 2019 that "investors don't need to wait on regulators who are asleep at the switch and unwilling or unable to regulate emissions properly . . . [t]hey can use their voting power to force change on companies who refuse to take their environmental emissions seriously. Investors have the power, and they have to use it."[583]

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[577] Armour & Gordon, *supra* note 495, at 44.
[578] Jennifer Rankin, *Greta Thunberg Tells EU: Your Climate Target Needs Doubling*, GUARDIAN (Feb. 21, 2019) https://www.theguardian.com/environment/2019/feb/21/greta-thunberg-tells-eu-your-greenhouse-gas-targets-are-too-low.
[579] Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J.L., FIN., & ACCT. 247, 249 (2017) (citing Roland Bénabou & Jean Tirole, *Individual and Corporate Social Responsibility*, 77 ECONOMICA 1 (2010)).
[580] Azar et al., *supra* note 555, at 6.
[581] Larry Fink, *A Sense of Purpose,* HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 17, 2018) https://corpgov.law.harvard.edu/2018/01/17/a-sense-of-purpose/.
[582] Letter from Larry Fink, Chairman and Chief Exec. Officer, BlackRock, to CEO, https://www.blackrock.com/americas-offshore/en/2019-larry-fink-ceo-letter.
[583] Hook & Tett, *supra* note 516.

There are various reasons why the Big Three may voluntarily assume the role of sustainable capitalists or "surrogate regulators"[584] engaging in "private environmental governance."[585] Firstly, it could reflect the rise in consumer demand for ESG funds and a desire on the part of the Big Three to attract and retain (millennial) investors who care about issues such as climate change.[586] Secondly, it could be a response to backlash from environmental activists who have targeted the Big Three for their poor record on climate voting.[587] Thirdly, and relatedly, it could be due to pressure from other investors the Big Three interact with, such as pension funds. Fourthly, it could be a precaution to avoid bad publicity and pre-empt regulation that might restrict the Big Three's power.[588] Finally, it could be based on "diversified investor self-interest" to mitigate the negative impact that climate change risk could have on a fully diversified index investment portfolio.[589]

As a final point, one advantage of efforts to mitigate climate change at the company and investor level is that large asset managers such as the Big Three invest in portfolio companies worldwide.[590] Their engagement and activism can transcend national borders and operate on a global scale. By contrast, governmental and regulatory efforts on climate change will either be limited to the national level or face signification coordination, collective action, and free rider problems on an international level. That said, it has also been noted by Condon that institutional investors' "economic incentive to mitigate the harms climate change impose on their portfolios . . . is not aligned with the *socially* optimal level of emissions reduction. Many of the most extreme costs of climate change will be

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[584] *See* Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1, 73 (2020).

[585] *See id.* at 72 (citing Michael P. Vandenbergh, *Private Environmental Governance*, 99 CORNELL L. REV. 129, 174 (2013)).

[586] *See generally* Barzuza et al., *supra* note 496 (arguing that index funds are competing to accumulate assets of the millennial generation who place a "significant premium" on social issues).

[587] *See supra* text accompanying note 514.

[588] *See* Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, 100 B.U. L. REV. 1771, 1798 (2020) ("Given the historical suspicion of concentrated economic power in the United States, BlackRock's CEO must worry about the prospect of regulation. The best way to avoid regulation is to be viewed by relevant audiences as a responsible steward.").

[589] *See* Condon, *supra* note 584, at 73.

[590] For example, BlackRock's Investment Stewardship Team has eight global offices and votes shares in more than eighty-five global markets. Blackrock, *Investment Stewardship: Acting on Behalf of Our Clients for the Long-Term*, https://www.blackrock.com/corporate/about-us/investment-stewardship. BlackRock also publishes an Investment Stewardship Global Engagement Summary Report, which highlighted that in the calendar year 2020, the asset manager had engaged with 1,740 companies in the Americas, 801 companies in Europe, Middle East, and Africa, and 960 companies in Asia Pacific. BLACKROCK, INVESTMENT STEWARDSHIP GLOBAL ENGAGEMENT SUMMARY REPORT 1 (2020), https://www.blackrock.com/corporate/literature/press-release/blk-engagement-summary-report-2020.pdf.

borne by those that do not participate in the global economy, and certainly not the economy that is reflected in asset valuation."[591] Consequently, "investor action to combat climate change will most certainly not be 'enough' from the perspective of the global population."[592] It is clear, therefore, that any action by the Big Three to adopt the role of sustainable capitalists — where they utilize their significant investor power to mitigate the effects of the climate crisis at the corporate level — can never be a complete solution. To be sure, Big Three intervention, or ESG investing, cannot be a substitute for a strong regulatory framework.[593] Moreover, the fact that the Big Three have the power to act as quasi-regulators also raises "important questions regarding democratic accountability and the potential to displace the role of 'traditional government,'"[594] as "the power to 'self-regulate' is the power to play a government-like role without the government's accountability to a democratic electorate."[595] BlackRock has already been called "the fourth branch of government"[596] and "the de-facto government based on Wall Street"[597] due to its immense power. However, given the urgency of the situation, and the relative inertia of governments to properly address the global climate crisis in a meaningful and urgent way, any progress that investors can make to mitigate corporate climate change damage would in itself be a valuable contribution to society.

II. THE AGENCY COSTS OF SUSTAINABLE CAPITALISM

Section I above introduced the Big Three in their assumed role as sustainable capitalists. This Section considers the agency costs associated with that assumption of responsibility. As passive index investors are fully diversified, they are sometimes thought of as a proxy

[591] Condon, *supra* note 584, at 67-68; *see also* Partnoy, *supra* note 538 (noting that "only about half of Americans own any stocks at all"). *See generally* Sanna Markkanen & Annela Anger-Kraavi, *Social Impacts of Climate Change Mitigation Policies and Their Implications for Inequality*, 19 CLIMATE POL'Y 827 (2019) (citing literature for the proposition that the poorest and marginalized populations — who are least responsible for past greenhouse gas emissions — are most vulnerable to climate change).
[592] Condon, *supra* note 584, at 68.
[593] *See* Ann M. Lipton, *ESG Investing, or, If You Can't Beat 'Em, Join 'Em*, *in* RESEARCH HANDBOOK ON CORPORATE PURPOSE AND PERSONHOOD 130, 146 (Elizbeth Pollman & Robert B. Thompson eds., 2021).
[594] Condon, *supra* note 584, at 65.
[595] *Id.* at 72.
[596] Annie Massa & Caleb Melby, *In Fink We Trust: BlackRock Is Now 'Fourth Branch of Government'*, BLOOMBERG BUSINESSWEEK (May 21, 2020), https://www.bloomberg.com/news/articles/2020-05-21/how-larry-fink-s-blackrock-is-helping-the-fed-with-bond-buying.
[597] Bill McKibben, *Can Wall Street's Heaviest Hitter Step Up to the Plate on Climate Change?*, NEW YORKER (Dec. 23, 2020), https://www.newyorker.com/news/annals-of-a-warming-planet/can-wall-streets-heaviest-hitter-step-up-to-the-plate-on-climate-change.

for the interests of the economy or society more broadly.[598] The gap between the interests of index investors and the interests of the Big Three represents an agency cost. This Section theorizes a dual problem that could be present in the sustainability context: the persistence of "rational reticence" among the Big Three (in some respects); and the emergence of a second potential problem, "rational hypocrisy." When considering rational reticence, an important distinction is drawn between reticence with regard to portfolio-wide sustainability initiatives and reticence with regard to firm-specific sustainability activism. The relevant monitoring shortfall that remains (either firm-specific or portfolio-wide activism), then affects the role ESG hedge funds and other socially responsible activists can play in addressing this, as discussed in Chapters 6 and 7.

A. Rational Reticence

In the archetypal Berle-Means corporation, shareholders were described as "rationally apathetic," due to collective action problems and coordination costs that inhibit widely dispersed shareholders from engaging in monitoring or activism.[599] As a result of the reconcentration of ownership among institutional investors,[600] Gilson and Gordon recharacterized institutional investors as "rationally reticent."[601] Rational reticence

[598] Of course, it would be overly simplistic to assume that all of the ultimate investors in passive index funds care about social welfare as well as financial returns. There is likely to be a wide divergence in investor goals and many passive index investors may only care about maximizing financial returns. If passive index fund managers aim only to maximize financial returns, however, there is an additional agency cost between the fund manager and those investors who do care about environmental and social goals. There are also investor-investor conflicts regarding goals.

[599] Black, *supra* note 481, at 527 (noting that "[t]he cost and futility of becoming informed leads shareholders to choose rational apathy"); *see* ROBERT C. CLARK, CORPORATE LAW 390-96 (1986) (noting that coordination costs for dispersed shareholders lead to rational apathy).

[600] By the 1990s in the U.S., the "Berle-Means Corporation" was an oversimplification of the reality of the majority of U.S. public companies. *See* Black, *supra* note 481, at 574 (noting that "the model of public companies as owned by thousands of anonymous shareholders simply isn't true. There are a limited number of large shareholders, and they know each other"); *see also* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1291 (1991) (noting that "[i]nstitutional ownership is disproportionately heavy at the upper end of corporate America"). In the intervening years, institutional ownership became even more pronounced. *See* Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 87 (2011) (noting that "[t]he proportion of shares of U.S. public companies held by domestic institutional investors rose from 14% in 1965 to 45% in 1985 and again to 65% in 2002"); *see also* Jennifer G. Hill, *The Trajectory of American Corporate Governance: Shareholder Empowerment and Private Ordering Combat*, 2019 U. ILL. L. REV. 507, 512 (2019) (noting that individual investors in the U.K. now hold only around 10% of listed U.K. equities); Charles McGrath, *80% of Equity Market Cap Held by Institutions*, PENSIONS & INVS. (Apr. 25, 2017), https://www.pionline.com/article/20170425/INTERACTIVE/170429926/80-of-equity-market-cap-held-by-institutions (noting that by 2017, institutional investors owned approximately 78% of the market value of U.S. companies and 80% of the S&P 500 index).

[601] Gilson & Gordon, *Agency Capitalism*, *supra* note 466, at 895.

describes a scenario where institutional investor intermediaries "have business models that limit their incentives and capacity to monitor the business choices of their portfolio companies," leading them to rationally prefer to exit a stock rather than exercise governance rights.[602] The underlying explanation for this reticence can be explained by reference to the competitive pressures that these funds are subject to. In essence, the portfolio managers of key investment intermediaries such as actively managed mutual funds and pension funds are incentivized to focus on relative performance at the lowest cost.[603] Even if it might be in the ultimate interests of the beneficiaries for the fund managers to engage in activism to improve the absolute performance of the fund, fund managers only capture a small fraction of the benefits from activism while bearing the full costs.[604] As the benefits will be enjoyed by all shareholders, other funds could free-ride on the activists' efforts without bearing any of the costs. Therefore, the incentive for any individual fund manager to engage in costly monitoring of portfolio companies, or to initiate firm-specific activism, is extremely limited.

This divergence in incentives results in institutional investors assigning "a low value to governance rights since their proactive exercise will not improve the relative performance on which the institutional investor's profitability and ability to attract assets depends."[605] Consequently, Gilson and Gordon theorized that such institutions would only "respond to proposals but are unlikely themselves to create them"[606] and that, at most, they "might engage in 'governance activism' not 'performance activism.'"[607] This gap between the interests of institutional investors and beneficial owners is described by Gilson and Gordon as "the agency costs of agency capitalism."[608]

As explained in Section I, there have been rapid changes to the investor landscape since Gilson and Gordon's theory on agency capitalism was advanced. Any new framework therefore needs to appropriately account for the rise of passive investing, the common ownership of the Big Three asset managers, and the growth of ESG investing. These

[602] *Id.* at 865.
[603] *Id.* at 889-95.
[604] Bebchuk et al., *supra* note 537, at 96-97; Gilson & Gordon, *Agency Capitalism*, *supra* note 466, at 889-90.
[605] Gilson & Gordon, *Agency Capitalism*, *supra* note 466, at 895.
[606] *Id.* at 867.
[607] *Id.* at 889.
[608] *Id.*

developments warrant a reconsideration of the problem of rational reticence that was exhibited by the active fund managers who were the focal point of Gilson and Gordon's agency capitalism theory.

When developing the concept of rational reticence, Gilson and Gordon highlighted three characteristics of (actively managed) mutual funds, with respect to power, reticence and responsiveness.[609] Firstly, in theory, mutual funds are incredibly powerful due to the significant levels of ownership concentration among institutional investors in recent decades. Secondly, in contrast, mutual funds are not proactive at all in terms of shareholder proposals. Thirdly, mutual funds are not entirely passive shareholders as they frequently oppose management on corporate governance issues such as poison pills and staggered boards.[610] Ultimately, Gilson and Gordon characterized such funds as "stubbornly responsive but not proactive."[611]

The general characteristics that Gilson and Gordon use to describe actively managed funds in terms of power, reticence and responsiveness also seem to hold true for passively managed funds generally and the Big Three asset managers specifically. Firstly, such funds potentially have immense power, especially given the increasing concentration of ownership among the Big Three. In fact, the Big Three's power and influence far exceeds that of smaller, actively managed mutual funds because the Big Three are now the largest shareholders in most economically significant corporations. Secondly, the Big Three are similarly not proactive in terms of putting forward shareholder proposals. In an empirical study, Bebchuk and Hirst noted that from 2007 to 2018, the Big Three have never submitted a single shareholder proposal.[612] Thirdly, the Big Three have demonstrated the potential to be more active in terms of portfolio-wide issues. Board gender diversity is the most prominent example of this.[613]

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[609] *Id.* at 886.
[610] *Id.* at 886-87.
[611] *Id.* at 888.
[612] Bebchuk & Hirst, *Index Funds*, *supra* note 478, at 2104; *see also* Paul Rissman & Diana Kearney, *Rise of the Shadow ESG Regulators: Investment Advisers, Sustainability Accounting, and Their Effects on Corporate Social Responsibility*, 49 ENV'T L. REP. 10155, 10173 (noting that "universal owners rarely, if ever, file shareholder resolutions, even for governance issues"); Attracta Mooney, *BlackRock Takes on Proxy Advisers in Dispute over Investor Rights*, FIN. TIMES (Nov. 24, 2018) https://www.ft.com/content/44110919-84d9-30d5-a346-e9ac30eef204 (noting that BlackRock has never filed a shareholder resolution).
[613] *See* Barzuza et al., *supra* note 496, at 1265-69. *See generally* Gormley et al., *supra* note 505 (discussing "The Big Three" institutional investors' campaigns to increase gender diversity on corporate boards).

More specifically, however, the Big Three — predominantly managing passive index funds — may have some different incentives than active fund managers. There has been a lively academic debate regarding the incentives of passive index fund managers outside of the context of sustainability[614] and there is also some scholarship on the incentives of passive index fund managers in the ESG context.[615] As a general principle, passive index funds cannot exit a stock that is a constituent of an index that the fund tracks. As noted by Vanguard's CEO, "our index funds cannot choose the shares in which they invest. We are essentially permanent capital and cannot turn the S&P 500 into the S&P 499."[616] The "exit" or "Wall Street Walk" option from Albert Hirschman's treatise on "exit, voice, and loyalty"[617] is not open to passive index funds. Pursuant to Hirschman's theory, "exit was shown to drive out voice . . . and it began to look as though voice is likely to play an

[614] *See generally* Bebchuk & Hirst, *Index Funds*, *supra* note 478 (arguing that index fund managers have strong incentives to underinvest in stewardship and to be excessively deferential to corporate managers); Bebchuk & Hirst, *The Specter*, *supra* note 485 (noting that the Giant Three scenario increases the importance of the agency problems afflicting passive index fund managers); Coates, *supra* note 478 (arguing that index funds have real influence and greater practical importance than simpler analytical approaches might suggest); Fichtner et al., *supra* note 482 (noting that the Big Three utilize coordinated voting strategies and follow a centralized corporate governance strategy and that they may exert "hidden power" through other channels); Fichtner & Heemskerk, *supra* note 523 (arguing that the ongoing debates on the rise of passive investing do not fully appreciate the transformative effect the Big Three could have as Permanent Universal Owners); Fisch et al., *supra* note 478 (arguing that as passive funds compete on both price and performance with other investment options, and benefit from economies of scale, they have a variety of incentives to engage effectively with companies in their portfolio); Kahan & Rock, *supra* note 588 (arguing that due to the enormous scale of their investments and the pivotal nature of their votes, the Big Three have the strongest incentives to ensure that companies in their portfolios are well run); Lund, *supra* note 529 (arguing that passive fund will rationally adhere to low cost governance interventions as they lack a financial incentive to ensure that their portfolio companies are well-run); John D. Morley, *Too Big to Be Activist*, 92 S. CAL. L. REV. 1407 (2019) (arguing that the biggest investment managers are too big to be activists).

[615] *See generally* Barzuza, Curtis & Webber, *supra* note 496 (arguing that the notion that index funds are passive owners overlooks that index funds have taken a leading role in challenging management and voting against directors in order to advance board diversity and corporate sustainability); Condon, *supra* note 584 (arguing that diversified investors should rationally be motivated to internalize intra-portfolio negative externalities and thus institutional investors can influence managerial decisions at the firm level for the benefit of their broader portfolio); Caleb N. Griffin, *Environmental and Social Voting at Index Funds*, 44 DEL. J. CORP. L. 167 (2020) (noting that despite the considerable marketing efforts of the Big Three with respect to their environmental and social efforts, overall support for environmental and social proposals is low at the Big Three); Giovanni Strampelli, *Can BlackRock Save the Planet? The Institutional Investors' Role in Stakeholder Capitalism*, 11 HARV. BUS. L. REV. (forthcoming) (arguing that there are reasons to doubt that institutional investors can perform a public function for the benefit of society at large and replace governmental or regulatory intervention).

[616] Cyrus Taraporevala, *Index Funds Must Be Activists to Serve Investors*, FIN. TIMES (July 24, 2018) https://www.ft.com/content/4e4c119a-8c25-11e8-affd-da9960227309.

[617] *See* ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINES IN FIRMS, ORGANIZATIONS, AND STATES 21-29 (1970); *see also* Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, 19 J. APPLIED CORP. FIN. 55, 56 (2007) [hereinafter *Evolution of Shareholder Activism*].

important role in organizations only on condition that exit is virtually ruled out."[618] This point was also made vividly by a principal at Vanguard, who noted "We're riding in a car we can't get out of, governance is the seat belt and air bag."[619] At first sight, therefore, it may seem as if passive investors would be *more* likely to utilize voice, given the unavailability of exit. Crucially, though, passive index funds do not compete on performance, as they offer what is essentially a commoditized product to investors. They also would still have to bear the costs of any activism and given the low cost of index funds, that would be borne on very thin margins.

In the context of the Big Three, a more nuanced examination of rational reticence is timely, as the incentives to engage in portfolio-wide sustainability initiatives may be much stronger than the incentives to initiate firm-specific ESG activism.

1. Portfolio-wide ESG Initiatives

The Big Three differ from the actors examined in the agency capitalism framework as they are common owners, and they increasingly manage ESG funds.[620] These factors could prompt the Big Three to engage in more active monitoring, at least on portfolio-wide ESG issues. A key principle of Modern Portfolio Theory is that investors can mitigate idiosyncratic (firm-specific) risk by diversifying their portfolios.[621] This is one of the major benefits of passive index funds, as investors are diversified across a huge range of companies. The Capital Asset Pricing Model also teaches us that investment involves two types of risk: systematic risk and unsystematic risk (or specific risk).[622] Diversification does not solve the problem of systematic risk, as even a portfolio holding all of the shares in the

[618] HIRSCHMAN, *supra* note 617, at 76; *see also* Coffee, *supra* note 600, at 1288 (noting that "if 'exit' is blocked, the members will become more interested in exercising a 'voice' in governance decisions").
[619] Sarah Krouse, David Benoit & Tom McGinty, *Meet the New Corporate Power Brokers: Passive Investors*, WALL ST. J. (Oct. 24, 2016) https://www.wsj.com/articles/the-new-corporate-power-brokers-passive-investors-1477320101.
[620] During 2020, sustainable funds in the United States continued to dominate fund flows, with assets under management reaching $236 billion due to inflows of $51.1 billion. BlackRock's iShare suite of ESG ETFs attracted $23.1 billion (or 45% of all sustainable fund flows) for the year. *See* Jon Hale, *A Broken Record: Flows for U.S. Sustainable Funds Again Reach New Heights*, MORNINGSTAR (Jan. 27, 2021) https://www.morningstar.com/articles/1019195/a-broken-record-flows-for-us-sustainable-funds-again-reach-new-heights.
[621] *See* Markowitz, *supra* note 527, at 89-90; *see also* Armour & Gordon, *supra* note 495, at 36.
[622] WILLIAM SHARPE, PORTFOLIO THEORY AND CAPITAL MARKETS 139-40 (1970).

stock market cannot eliminate systematic risk.[623] Climate change has been described both as a systematic risk[624] and a systemic risk.[625] It "cannot be eliminated through diversification because its effects are felt economy-wide."[626] The climate crisis — if it continues unabated — will inevitably impose devastating losses on society, both in economic and other terms. Similar to the losses imposed by a financial crisis, the losses caused by climate change are likely to be "characteristically widely diffused, indirect and in aggregate very large."[627] As Armour and Gordon have noted, "the firm's majoritarian diversified shareholders," cannot eliminate systemic risk and thus "would prefer that the managers did not impose systemic externalities."[628] Therefore, it is clear that the interests of different types of shareholders — especially with regard to portfolio-wide risk — are not homogenous.[629] The interests of fully diversified passive index investors can differ markedly from the interests of more concentrated shareholders who may be primarily concerned with increasing firm-specific value, due to their active, stock-picking, investment strategies.

Hart and Zingales noted that shareholders with diversified portfolios are "interested in total market return rather than the value of a particular firm."[630] In a similar vein, Gilson and Kraakman argued that the "surest way to increase the value of an indexed stock portfolio is to increase the value of all of the companies in the portfolio."[631] They hypothesized that the "only plausible" way to do this is by "improving the corporate governance *system* rather than by attempting to improve the management of particular companies."[632] Beginning in the 1990s, institutional investors such as public pension funds

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[623] *See* John C. Coffee, *The Future of Disclosure: ESG, Common Ownership, and Systemic Risk* 11 (Eur. Corp. Governance Inst., Working Paper No. 541/2020, 2021) (citing RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 168-70 (10th ed. 2011).

[624] *Id.* at 14 (noting "[c]limate change probably presents the clearest example of systematic risk").

[625] Although these terms are notoriously hard to define and are often used interchangeably, they refer to different risks. Systematic risk tends to involve vulnerability to events which affect aggregate outcomes such as broad market returns, including major weather catastrophes and pandemics. Systemic risk, while difficult to define, can be taken for present purposes to encompass the risk of collapse of an entire market or sector of the financial system. It is typically associated with financial crises that have a cascading effect on the market.

[626] Condon, *supra* note 584, at 17.

[627] Armour & Gordon, *supra* note 495, at 40 (describing the losses caused by the global financial crisis).

[628] *Id.* at 39.

[629] *See generally* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561 (arguing that the interests of public company shareholders are not in harmony with each other).

[630] Hart & Zingales, *supra* note 579, at 251.

[631] Gilson & Kraakman, *supra* note 558, at 867.

[632] *Id.*

protected the "system" by securing portfolio-wide governance improvements, including dismantling takeover defenses.[633] Similarly, portfolio-wide benefits can be pursued in relation to climate change risk.

The climate crisis — as well as being the most severe threat to life on earth — poses the most significant risk to the economy. Estimating the magnitude of the damage that climate change will inflict upon investment portfolios is a very challenging task, given that estimating the effect of climate change on the economy more broadly is also extremely difficult.[634] However, the expected damage to the Big Three's investment portfolios is likely to be vast.[635] As outlined above, this damage is not something investors can avoid by diversifying their portfolios, and in fact it is the most diversified investors — who broadly represent the economy and society — who should logically be the most concerned about such climate change risk.

As a result, Condon's conclusion that "institutional investors, contrary to the traditional assumptions of investor passivity, have both the incentive and the capacity to serve as monitors of corporate behavior, so long as returns are justified at the portfolio level" seems theoretically sound.[636] In particular, the effect of common ownership among index investors should rationally translate into a willingness to internalize negative externalities — specifically to minimize the risks associated with climate change, given its detrimental effect at the portfolio level.[637] Put simply by Condon, "[a]s 'universal owners,' it is in their financial self-interest to take action to reduce global emissions, including those generated by the publicly traded fossil fuel companies in which they invest."[638] Coffee similarly notes that "[g]iven high common ownership across a broad portfolio, it becomes rational and predictable that diversified institutional investors will make both investment and voting decisions on a portfolio-wide basis (rather than simply trying to maximize the value of

[633] *Id.* at 867-71; *see also* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 877 (noting that in the early 2000s, four types of precatory resolutions did obtain support: proposals to repeal classified boards (average 62% of votes); proposals calling for the elimination of supermajority provisions (average 60% of votes); proposals calling for rescission of poison pills (average 59%); and proposals for shareholder approval of future golden parachutes (average 53%)).
[634] Condon, *supra* note 584, at 43.
[635] *See id.* at 45.
[636] *Id.* at 10.
[637] *Id.* at 12.
[638] *Id.* at 6.

individual stocks)."[639] It is rational for the Big Three to take action to try to reduce the risk of climate change on a portfolio-wide basis, even if such action causes losses to some companies in their portfolio.[640]

Therefore, if the Big Three properly account for the expected damage to portfolio-wide returns in the future due to the impact of climate change, they should be incentivized to mitigate climate risk at the portfolio level. Other commentators have likewise argued that "passive investors have meaningful monitoring incentives when it comes to cross-cutting issues such as sustainability," where large investors such as the Big Three can exploit economies of scale to make a meaningful impact.[641] The theoretical impact of this cannot be overstated. Coffee argues that "the advent of portfolio-wide decision-making (both as to investments and voting) may represent the most important contemporary change in institutional investor behavior,"[642] solving a "problem that has frustrated legal scholars for decades" and finding "a strategy to make public corporations behave more virtuously."[643]

To conclude, when analyzing rational reticence in the context of sustainable capitalism, theoretically the Big Three should exhibit less rational reticence on portfolio-wide sustainability issues than their active fund manager counterparts. It makes rational sense for the Big Three to replicate or even go beyond the successful portfolio-wide governance changes that were proposed by institutional investors in earlier decades.

2. Firm-specific ESG Activism

Compared to an actively managed fund that could, theoretically, improve its relative performance by overweighting a specific stock then investing in activism or engagement,[644] a passive index fund manager has minimal incentives to engage in firm-specific monitoring and activism, as there is no real way for passive funds to compete on the basis of performance with other index funds that mechanically track the same index. The business model of passive index investing is simply to replicate the performance of specific stock

[639] Coffee, *supra* note 623, at 5.
[640] *Id.* at 15.
[641] Azar et al., *supra* note 555, at 6 (citing Ian R. Appel, Todd A. Gormley & Donald B. Keim, *Passive Investors, Not Passive Owners*, 121 J. FIN. ECON. 111 and Gormley et al., *supra* note 505).
[642] Coffee, *supra* note 623, at 42.
[643] *Id.* at 43.
[644] Lund, *supra* note 529, at 501.

market indices and to minimize the costs for end investors. Unlike actively managed funds, index funds are "essentially commodities"[645] that compete on cost rather than relative performance. Davies has noted that "the incentives for managers of index funds to engage at a deep level appears to be very low, even non-existent, despite the fact that such funds are locked in long term to the relevant index."[646] Despite the inability to exit, passive index fund managers may be much less likely than active fund managers to engage in firm-specific performance activism. Therefore, when considering firm-specific monitoring and activism, the rise of passive investing and common ownership would, logically, appear to exacerbate the problem of rational reticence.

Condon does argue that institutions such as the Big Three have incentives to pursue firm-specific engagement in order to protect portfolio-wide returns.[647] This would appear to make sense, up to a point. Low-cost firm-specific intervention by the Big Three might be rational. However, free-rider problems loom large when it comes to higher cost firm-specific activism.[648] There are ways to mitigate collective action and free rider problems. For example, institutional investors can form investor coalitions to coordinate action.[649] Coalitions such as Climate Action 100+ explicitly foster asset manager coordination.[650] Therefore, some minimal levels of firm-specific or coordinated sustainability activism may be rational on the part of the Big Three. However, this is very unlikely to stretch to firm-specific strategic or operational activism involving, for example, detailed and tailored energy transition plans at target companies. Predominantly, rational reticence with respect to firm-specific sustainability activism can be expected to prevail.[651]

B. Rational Hypocrisy

The second problem that could afflict the Big Three specifically in the sustainable capitalism framework is what I call "rational hypocrisy." Hypocrisy is typically defined as claiming to have higher standards or more noble beliefs than is actually the case in

[645] Kahan & Rock, *supra* note 588, at 1783.
[646] Davies, *supra* note 576, at 77.
[647] Condon, *supra* note 584, at 61.
[648] *See* Bebchuk & Hirst, *Index Funds*, *supra* note 478, at 2052 (noting the free-rider problem arises as "index fund investors will not fully capture the gains to the portfolio company from the investment in stewardship").
[649] Condon, *supra* note 584, at 61.
[650] *Id.* at 64.
[651] Excluded from this discussion are cases where firm-specific intervention also has systemic consequences.

practice.[652] The concept of "corporate hypocrisy" has been coined for "a firm that claims to be something that it is not."[653] In essence, a company will be perceived as insincere if it behaves in a manner that is inconsistent with or that falls short of its self-proclaimed standards of social responsibility or if the company "says and does two different things.''[654] In a similar vein, this Chapter introduces the concept of "rational hypocrisy" as a potential agency cost arising from the Big Three's assumed role as sustainable capitalists. In the media, BlackRock (in particular) has been regularly accused by various environmental activists as being hypocritical due to discrepancies between its public statements on climate risk and its actions in practice. To cite some examples, in 2016 BlackRock and Vanguard were labelled "hypocritical" after they failed to support a shareholder resolution at ExxonMobil which put them at odds with their commitments as signatories of the Principles of Responsible Investment.[655] Similarly, BlackRock was accused of "climate change hypocrisy" after it refused to support two landmark environmental shareholder resolutions at Australian oil companies Woodside Energy and Santos that received high levels of support from other investors.[656] This led Majority Action to proclaim that "BlackRock joined Climate Action 100+ and enjoyed celebrity as a result of having done so, but has then made a mockery of its own commitment by voting to undermine its objectives."[657]

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[652] "Hypocrisy" is defined in the Oxford English Dictionary as "[t]he assuming of a false appearance of virtue or goodness, with dissimilation of real character or inclinations."

[653] Tillmann Wagner, Richard J. Lutz & Barton A. Weitz, *Corporate Hypocrisy: Overcoming the Threat of Inconsistent Corporate Social Responsibility Perceptions*, 73 J. MARKETING 77, 79 (2009) [hereinafter *Corporate Hypocrisy*]. The concept of "corporate hypocrisy" was first introduced in the marketing literature in 2009 but has also been examined in other disciplines such as management and organizational science, business ethics and social psychology. *See* Tillmann Wagner, Daniel Korschun & Cord-Christian Troebs, *Deconstructing Corporate Hypocrisy: A Delineation of Its Behavioral, Moral, and Attributional Facets*, 114 J. BUS. RSCH. 385, 391 (2020).

[654] *See* Wagner et al., *Corporate Hypocrisy*, *supra* note 653, at 90.

[655] Laurie Havelock, *BlackRock, Vanguard Among 'Hypocritical' Investors Ditching PRI Agreement over Exxon Vote, Says AODP*, RESPONSIBLE INV. (Sept. 8, 2016), https://www.responsible-investor.com/articles/blackrock-vanguard-among-hypocritical-investors-ditching-pri-agreement-over.

[656] Attracta Mooney, *BlackRock Accused of Climate Change Hypocrisy,* FIN. TIMES (May 17, 2020), https://www.ft.com/content/0e489444-2783-4f6e-a006-aa8126d2ff46.

[657] John Greenwood, *BlackRock 'Undermining Objectives of Climate Coalition It Just Joined' — Majority Action*, CORP. ADVISER (Dec. 14, 2020), https://corporate-adviser.com/blackrock-undermining-objectives-of-climate-coalition-it-just-joined-majority-action/; *see also* MAJORITY ACTION, CLIMATE IN THE BOARDROOM: HOW ASSET MANAGER VOTING SHAPED CORPORATE CLIMATE ACTION IN 2020, at 5 (2020) https://www.majorityaction.us/asset-manager-report-2020 [hereinafter 2020 CORPORATE CLIMATE ACTION] (noting that BlackRock voted against ten of the twelve shareholder proposals flagged by Climate Action 100+ in 2020).

Various studies highlight that the Big Three's voting records with respect to climate-critical resolutions do not match the asset managers' public statements. For example, a 2019 study identified forty-one climate-critical resolutions submitted to corporations and highlighted that BlackRock only voted in favor of five and Vanguard only voted in favor of four.[658] In 2020, BlackRock was further criticized for its voting record which revealed that it had supported fewer climate resolutions than in previous years, despite Larry Fink's heavily publicized commitment to such initiatives at the beginning of the year.[659] A study by Griffin also concludes that the major motivation of the Big Three may be to "be *perceived by potential customers* as taking positive action on E&S [environmental and social] issues."[660] Overall, an examination of the Big Three's voting records — and particularly the voting records of ESG funds which are often voted universally in tandem with ordinary index funds[661] — could be used to support the view that the Big Three do not sufficiently represent the interests of their ultimate investors, the economy, or society. An important caveat to this conclusion is that a focus on voting records alone may be misconceived as the Big Three favor engaging with companies over voting against management. It was reported in 2018 that "certain asset managers, including BlackRock, refuse to vote in favor of shareholder proposals if the companies concerned are engaging with the asset manager."[662] Despite the Big Three's failure to provide significant voting support to shareholder proposals related to climate change, there is some evidence that their more informal "engagement" with portfolio companies may be associated with lower greenhouse gas emissions. An empirical study by Azar, Duro, Kadach and Ormazabal finds that firms with higher CO_2 emissions are more likely to be the target of Big Three engagements and that engagements are followed by a reduction in CO_2 emissions. This provides preliminary evidence that the "engagement" efforts of the Big Three's stewardship teams may be associated with some positive climate action on the part of the worst corporate climate change offenders.

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[658] MAJORITY ACTION, 2019 CORPORATE CLIMATE ACTION, *supra* note 512, at 4.

[659] Attracta Mooney, *BlackRock Criticized over Drop in Climate Votes*, FIN. TIMES (Oct. 4, 2020), https://www.ft.com/content/7a80f33b-a0ed-4dea-b2d3-ce56381f4084 (noting that BlackRock supported just 6% of environmental proposals filed by shareholders globally in the twelve months to June, down from 8% in the previous year).

[660] Griffin, *supra* note 615, at 170.

[661] Scott Hirst, *Social Responsibility Resolutions*, 43 J. CORP. L. 217, 220 (2018) (highlighting that mutual funds could adopt policies whereby they would split their vote in proportions consistent with the preferences of their investors but noting that vote splitting is currently rare).

[662] KIMBERLY GLADMAN, ASSET MANAGER CLIMATE SCORECARD 2018, at 1 (2018), https://5050climate.org/wp-content/uploads/2018/09/FINAL-2018-Climate-Scorecard-1.pdf.

In any event, there are various reasons why the Big Three might be incentivized to engage in rational hypocrisy. Being *perceived* as environmentally or socially conscious could bring greater or equal benefit to the Big Three than going through the costly process of substantively challenging managers on tough issues in a meaningful way. The former approach could help the Big Three to attract investors' money. There has been a dramatic rise in ESG investment products in recent years. Throughout 2019 and 2020, record sums were invested in socially responsible index funds. The market share of ESG funds is still small relative to the $41 trillion held by investment funds worldwide, but it has grown exponentially in the last two years.[663] Assets under management in ESG funds exceeded the $1 trillion mark by mid-2020.[664] In Europe — which is the leading market for such funds — ESG funds are predicted to outnumber traditional funds as soon as 2025.[665] As noted by Barzuza, Curtis and Webber, "index funds are locked in a fierce contest to win the soon-to-accumulate assets of the millennial generation, who place a significant premium on social issues in their economic lives."[666] They posit that "signaling a commitment to social issues is one of the few dimensions on which index funds can differentiate themselves and avoid commoditization."[667] Bebchuk and Hirst argue that "index fund managers will have an incentive to avoid being perceived as inferior stewards" by their current and potential customers, and therefore will "have an incentive to emphasize their commitment to stewardship in their public communications."[668] They also note that this could "lead index fund managers to take positions on subjects that they expect to appeal to such investors, such as gender diversity on boards and climate change disclosure."[669] The impression of responsible stewardship could also mitigate consumer and employee backlash against the Big Three.

On the other hand, actually challenging corporate management on issues that may strike at the core of a company's business could be risky and controversial. As Choudhury and Petrin note, "environmental issues pose a unique challenge to business in that

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[663] Siobhan Riding, *ESG Funds Attract Record Inflows During Crisis*, FIN. TIMES (Aug. 9, 2020) https://www.ft.com/content/27025f35-283f-4956-b6a0-0adbfd4c7a0e.
[664] *Id.*
[665] Siobhan Riding, *ESG Funds Forecast to Outnumber Conventional Funds by 2025*, FIN. TIMES (Oct. 17, 2020) https://www.ft.com/content/5cd6e923-81e0-4557-8cff-a02fb5e01d42.
[666] Barzuza et al., *supra* note 496, at 1244.
[667] *Id.*
[668] Bebchuk & Hirst, *Index Funds*, *supra* note 478, at 2072-73.
[669] *Id.* at 2073.

environmental protection may be fundamentally at odds with a specific corporation's core functions."[670] Therefore, an aggressive stance on these issues could jeopardize other business that the Big Three receive from the companies they invest in. Moreover, both politically and in the common ownership literature, the Big Three's escalating power is increasingly scrutinized.[671] Intervening on firm-specific issues could heighten the risk of regulation curbing their power.

This Chapter generally proceeds on the assumption that fully diversified end investors — especially those who have explicitly chosen to invest in bespoke ESG index funds — should *rationally* care about climate change mitigation. However, it is important to acknowledge that it is possible, and perhaps likely, that some end investors themselves are similarly ambiguous or conflicted about the extent to which they wish the Big Three to pursue ESG objectives. Therefore, there is some potential tension among investors themselves. This could be true even of investors who choose to invest in ESG funds. ESG funds have recently been marketed as performing better financially compared to non-ESG funds.[672] However, continued financial success is not guaranteed; "doing well" may not always align with "doing good." The preferences of end investors would be more apparent if a tradeoff was required between "doing well" and "doing good." There may also be tension between investors who invest in ESG funds. Investors in a particular fund are likely to have a mix of preferences. Some investors may be willing to trade off financial returns against environmental and social goals to a much larger extent than other investors, who may expect the fund only to pursue "win-win" scenarios where financial returns are maximized while also advancing environmental and social goals. The Big

[670] BARNALI CHOUDHURY & MARTIN PETRIN, CORPORATE DUTIES TO THE PUBLIC 242 (2019).
[671] *See generally* José Azar, Martin C. Schmalz & Isabel Tecu, *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018) (arguing that diversification and good governance come with the hidden cost of reduced competition because few large institutional investors hold the majority of the market); Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (2016) (exploring how horizontal shareholding often can lead to anticompetitive market environment); Eric A. Posner, Fiona M. Scott Morton & E. Glen Weyl, *A Proposal to Limit the Anticompetitive Power of Institutional Investors*, 81 ANTITRUST L.J. 669 (2017) (proposing that the Department of Justice and Federal Trade Commission should enforce the Clayton Act against institutional owners who own stakes in many competing firms); Graham Steele, *The New Money Trust: How Large Money Managers Control Our Economy and What We Can Do About It* (Am. Econ. Liberties Project, Working Paper Series on Corp. Power #8, 2020), https://www.economicliberties.us/wp-content/uploads/2020/11/Working-Paper-Series-on-Corporate-Power_8_FINAL.pdf (discussing the issue of the growing dominance in financial markets by only few institutional investors, such as the Big Three).
[672] Siobhan Riding, *Majority of ESG Funds Outperform Wider Market over 10 Years*, FIN. TIMES (June 13, 2020), https://www.legis.nd.gov/assembly/67-2021/testimony/SNATRES-2291-20210204-4684-A-GAWRYLOW_DUSTIN_N.pdf.

Three may be cautious to take bold steps towards sustainable capitalism if there is a risk of this adversely affecting financial performance as their ultimate investors may not be willing to promote ESG goals at the expense of higher returns, especially if investors have mixed preferences which is likely to be the case. Therefore, the hypocrisy on the part of the Big Three may also be rational *because* it reflects the ambivalence of at least some end investors. In those cases, it would not be an agency cost because the approach would not conflict with the preferences of end investors. In other cases, the Big Three's ambivalence would be an issue for some end investors but not others. Therefore, it would represent an agency cost for some investors who are willing to receive a reduced financial return in favor of environmental and social goals, but not for others who are focused on maximizing financial returns.

Chapter 6 – ESG Hedge Fund Activism

I. THE ORIGINAL GOVERNANCE ARBITRAGEUR: ACTIVIST HEDGE FUNDS

Chapter 5 identified and theorized a dual problem that could arise from the Big Three's assumed role as sustainable capitalists — rational reticence and rational hypocrisy. Parallels can be drawn between the sustainable capitalism framework and the agency capitalism framework, as a monitoring shortfall similarly exists. In the agency capitalism framework, the solution that was identified by Gilson and Gordon was for activist hedge funds to fill the monitoring shortfall left by institutional investors.[673] Such activists played the role of governance intermediaries or arbitrageurs. Specifically, they were specialists in initiating firm-specific activist campaigns at companies where institutional investors were rationally reticent.[674] In the realm of sustainable capitalism, a vocal minority of activist hedge funds have already transitioned to focus on firm-specific ESG activism. In this respect, it is useful to reflect back upon the evolution of activist hedge fund strategies that was discussed in Chapters 3 and 4 to highlight how hedge funds adapted their strategies to fill the monitoring shortfall left by institutional investors. Especially important in this regard is how activist hedge fund campaigns evolved to effectively complement and appeal to the interests of the investors who will ultimately decide upon the success or failure of their campaigns.

[673] It is important to acknowledge that Gilson & Gordon's agency capitalism framework "provides a generally optimistic assessment of the potential role of institutional investors in contemporary corporate governance" whereas other commentators, such as Martin Lipton, have criticized institutional investor voting power as being "harnessed by a gaggle of activist hedge funds." *See* Hill, *supra* note 600, at 537 (citing Martin Lipton, *Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 26, 2013), https://corpgov.law.harvard.edu/2013/02/26/bite-the-apple-poison-the-apple-paralyze-the-company-wreck-the-economy/).

[674] Two examples of such campaigns are Starboard Value's campaign at Darden Restaurants in 2014, which included a very detailed 294-page turnaround plan for the Olive Garden restaurant chain and Trian Partners' campaign at Procter & Gamble in 2017, where Trian put forward a 93-page whitepaper on revitalizing P&G. *See* STARBOARD VALUE, *supra* note 290; TRIAN PARTNERS, REVITALIZE P&G TOGETHER 4 (2017), https://trianpartners.com/wp-content/uploads/2017/01/Trian-PG-White-Paper-9.6.17-1.pdf.

A. Activism 1.0 — Financial Engineering

Whether activist hedge funds represent a positive or negative force is a polarizing topic.[675] Most commonly, activist hedge funds are criticized for having a "bias toward near-term gain, regardless of . . . the interests of long-term investors, and the productivity of the wider economy."[676] Here, I label the most commonly criticized form of hedge fund activism *Activism 1.0. Activism 1.0* is defined as activism involving financial engineering or balance sheet activism. These are the types of demands that politicians and the media most commonly (and most negatively) associate with hedge fund activism. This form of activism generally involves a direct intervention on financial matters, such as pressuring the target company to increase leverage or return cash to shareholders via dividends or share buybacks.

In 2007, Bratton noted that hedge fund demands "likely include one or more actions assuring a quick return on investment."[677] This was demonstrated through an empirical study of activist hedge fund interventions from 2002 to 2006.[678] As noted in Chapter 3, in the early 2000s, there was some evidence that activists may have "grabbed low-hanging fruit" and targeted cash rich companies to redistribute cash to shareholders.[679] Such financially-oriented strategies are also logically consistent with the business model of activist hedge funds as they seek to quickly generate abnormal returns in order to increase the value of their funds. Hedge funds pursue absolute returns, often over short time periods.[680] An easy target for an activist hedge fund would therefore be a cash-rich firm. Other tactics that can generate short-term gains for hedge funds include seeking to change the capital structure of the company by repurchasing shares or expanding leverage, or demanding companies dispose of assets or initiate cost-cutting measures.[681]

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[675] *See* Strine, *Who Bleeds*, *supra* note 1, at 1871 ("Few topics are sexier among commentators on corporate governance now than whether activist hedge funds are good for, a danger to, or of no real consequence to public corporations and the people who depend upon them.").
[676] Bratton, *supra* note 272, at 1379.
[677] *Id*.
[678] *See id.* at 1385-87.
[679] *Id.* at 1394-95.
[680] *See* Coffee & Palia, *supra* note 56, at 567, 572 (noting that "activists specialize in short-term interventions" and "few activist hedge funds have held their stock for anything approaching three years"); Strine, *Who Bleeds*, *supra* note 1, at 1892 (noting that "[t]he rise that most hedge funds seek must occur within a relatively short time period, because many activist hedge funds have historically retained their positions for only one to two years at most").
[681] IRIS H.-Y. CHIU, THE FOUNDATIONS AND ANATOMY OF SHAREHOLDER ACTIVISM 77 (2010).

B. Activism 2.0 — Activist Directors

However, as Chapter 4 illustrated, *Activism 1.0* is a simplistic and outdated view of modern-day hedge fund activism. Activist hedge fund tactics constantly evolve and have been adapted (potentially to appeal to the interests of long-term investors). In the preceding decade, activist hedge funds have increasingly sought to secure minority representation on the boards of target companies, with this now being the most common form of hedge fund activism. As detailed in Chapter 4, since 2010 over one hundred S&P 500 companies in the U.S. have been targeted by activist hedge funds seeking activist board representation. Activist board representation campaigns are increasingly successful. The data showed that activist hedge funds secured at least one board seat in over 85% of the S&P 500 companies that were targeted.

Activist hedge funds could not succeed in such bold campaigns to change the board structure and corporate strategy of major U.S. companies alone. The average activist hedge fund holding in such campaigns at S&P 500 companies is just over 6%. Therefore, support from the institutional investors who hold a much larger proportion of the shares is necessary. Activist board representation is a specific type of intervention that may appeal to long-term institutional investors. When activist hedge funds secure board representation, they hold shares for longer periods compared to cases where no board representation is involved. Board representation campaigns are also most often accompanied by the activist hedge funds submitting extremely detailed business plans and proposals for long-term strategic and operational improvements at target companies. The longer-term, and more substantive, commitment on the part of hedge fund activist to the target company in *Activism 2.0* can thus mitigate some of the traditional concerns associated with the short-term "hit-and-run" motives and financial wizardry associated with activist hedge funds. Given that hedge funds are acutely aware that they need the support of long-term investors to succeed in their campaigns,[682] the growth of activist board representation campaigns could be a reflection of activist hedge funds evolving and adapting to effectively mirror the incentives and priorities of institutional investors such as the Big Three.

[682] Institutional investors have been described as the "corporate equivalent of swing voters in politics." Hill, *supra* note 600, at 539-40.

Activist hedge funds are unique in pursuing this form of firm-specific activism that other investors neither have the capacity nor the incentives to initiate. No other type of activist specializes in the appointment of activist directors who focus on strategy, operations, and turnaround. These new strategies have therefore cemented activist hedge funds' position as the principal governance arbitrageurs in the corporate governance ecosystem. In the early 1990s, Gilson and Kraakman had proposed an agenda for institutional investors, envisaging that they could collectively nominate professional outside directors who would actively monitor public corporations in the shareholders' interest.[683] These aspirations did not materialize, and instead activist hedge funds adapted their strategies to fulfil this role. The Big Three (like other institutional investors) are also rationally reticent in this regard. They have not, to date, personally nominated directors to the boards of their portfolio companies. In an empirical study, Bebchuk and Hirst noted that from 2007 to 2018, the Big Three did not submit a single director nomination nor did they make any suggestions for particular directors to be added or removed through their engagement activities.[684]

As already noted, activist hedge funds combine minority board representation with detailed plans to implement operational and strategic turnarounds. Again, this is something that institutional investors, such as the Big Three, would lack the incentives and resources to do themselves. The Big Three are not in the business of analyzing portfolio companies' strategies and operations in depth and formulating alternative, complex, business plans. Jahnke has noted that "while the asset management industry demands good corporate governance and transparency, most investors stop short of demanding changes to companies' business strategy."[685] On the other hand, the Big Three may be appropriately placed to act as an arbiter when presented with conflicting plans from the incumbent management and the activists. Davies argues that while index investors do not appear to be reliable initiators, they may be as well placed as anyone else to evaluate the impact of an activist hedge fund proposal.[686]

[683] Gilson & Kraakman, *supra* note 558, at 883-84.
[684] Bebchuk & Hirst, *Index Funds*, *supra* note 478, at 2098.
[685] Jahnke, *supra* note 563, at 7.
[686] Paul L. Davies, *The UK Stewardship Code 2010-2020: From Saving the Company to Saving the Planet?* 13-14 (Eur. Corp. Governance Inst., Working Paper No. 506/2020, 2020).

Therefore, it is clear that activist hedge funds can fill the gap left by a lack of intensive, firm-specific monitoring by more traditional institutional investors. The form of monitoring pursued in *Activism 2.0* still fits with activist hedge funds' business model. Although they hold minority stakes in target companies, they are undiversified investors who hold concentrated positions in a small number of portfolio companies. As a result, they are willing to engage in "firm-specific agitation to a degree unheard of among traditional institutional investors."[687]

C. Activism 3.0 — ESG Activism?

Traditionally, activist hedge funds have not promoted sustainability goals, nor have they launched activist campaigns with environmental or social components. The data collected in my empirical study discussed in Chapter 4 revealed that from 2010 to June 2022, there were only six activist hedge fund campaigns at S&P 500 companies that were publicized as involving environmental or social elements.[688] Each of those campaigns took place from 2018 onwards, which coincided with the launch of specialist ESG-focused activist funds. Previously, some companies may have hesitated to promote renewable energy or focus on long-term sustainability projects for fear of being an easy target for a traditional activist hedge fund attack. One prominent example of this eventuality materializing is Elliott Management's campaign at NRG Energy in 2017. NRG Energy, America's biggest independent power producer, was targeted after its share price declined by 60% when it became a "champion of renewable energy."[689] Activists Elliott Management and Bluescape Energy Partners were successful in appointing two directors to NRG's board.[690]

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[687] Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1091-92 (2007).

[688] The campaigns were: (1) ValueAct's January 2018 campaign at international power producer AES Corporation; (2) Jana's January 2018 campaign at Apple; (3) Elliott Management's 2020 campaign at Evergy; (4) Engine No. 1's 2020 campaign at ExxonMobil; (5) Carl Icahn's 2022 campaign at McDonald's; (6) Carl Icahn's 2022 campaign at Kroger. ValueAct's campaign at AES coincided with the launch of its new ValueAct Spring Fund and Jana's campaign at Apple coincided with the launch of Jana Impact Capital. There was one additional campaign by Trian Fund Management in October 2018 at the paint company PPG that referred to "ESG" goals. However, on closer examination, the campaign appeared to be entirely focused on governance, rather than any environmental or social factors. *See* TRIAN PARTNERS, PPG: MORE THAN A FRESH COAT OF PAINT 3, 37 (2018), https://www.10xebitda.com/wp-content/uploads/2020/03/Trian-PPG-Presentation-October-2018.pdf.

[689] David Gelles, *How Producing Clean Power Turned Out to Be a Messy Business*, N.Y. TIMES (Aug. 13, 2016), https://www.nytimes.com/2016/08/14/business/energy-environment/how-producing-clean-power-turned-out-to-be-a-messy-business.html.

[690] Michael Flaherty, *UPDATE 1-NRG Names Two Directors in Deal with Elliott and Bluescape*, REUTERS (Feb. 13, 2017), https://www.reuters.com/article/nrg-energy-elliott-idCNL4N1FY3Z8.

This led to conflicts with other shareholders, such as the New York City Pension Fund, as one of the nominees was a known climate-change denier who had repeatedly said global warming was not caused by carbon emissions and who labelled climate change a "hoax."[691] NRG ultimately announced a plan to divest its $4 billion renewable energy business, which caused a daily share price rise of around 25%[692] (increasing the value of Elliott's stake by approximately $58 million in one day).[693] Following the intervention, the company's shares were the best performing stock in the S&P 500 in 2017.[694] Elliott received similar criticism for its campaign at S&P 500 company Sempra energy in 2018, which partly focused on the firm divesting renewable energy assets.[695] Therefore, based on this anecdotal evidence, activist hedge funds may not seem to be the most likely candidates to pursue environmental or social goals.

However, the tides began to turn in 2018. In the last few years, activist hedge funds have begun to launch bespoke ESG funds and initiate campaigns where ESG issues are the primary or a core focus.[696] One of the first forays by activist hedge funds into the ESG investing space was witnessed in January 2018 when hedge fund Jana Partners announced the launch of Jana Impact Capital.[697] In a highly publicized endeavor, Jana enlisted the help of social activists, rock star Sting, and a former fund manager of BlackRock for its new impact fund, which was described in the press as "a convergence of Wall Street's roughest fighters and its do-gooders."[698] The fund's first headline activist campaign was

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[691] Ed Crooks, *Activists Clash over Direction for NRG Energy*, FIN. TIMES (Apr. 9, 2017), https://www.ft.com/content/89417ba2-1d3e-11e7-a454-ab04428977f9.

[692] Tom DiChristopher, *Hedge Fund Titan Paul Singer Scores Big Win After NRG Energy Surges 25% in Single Day*, CNBC (July 12, 2017), https://www.cnbc.com/2017/07/12/hedge-fund-titan-paul-singer-scored-a-big-win-with-this-energy-bet.html.

[693] Tina Davis, *Paul Singer Made $57.6 Million in One Day on This Bet*, BLOOMBERG (July 12, 2017), https://www.bloomberg.com/news/articles/2017-07-12/singer-s-elliott-made-57-6-million-on-one-bet-in-one-day-chart.

[694] Ed Crooks & Lindsay Fortado, *Elliott Takes Stake in Sempra Energy, Calls for Strategic Review and Board Shake-Up*, FIN. TIMES (June 11, 2018), https://www.ft.com/content/d00fc274-6d82-11e8-852d-d8b934ff5ffa.

[695] Tom DiChristopher, *Activist Investor Paul Singer Just Chose Sempra Energy as His Next Turnaround Project*, CNBC (June 11, 2018), https://www.cnbc.com/2018/06/11/elliott-management-launches-bid-to-overhaul-sempra-energy.html.

[696] *See*, *e.g.*, David Faber, *Jeff Ubben's ValueAct Launching Fund with Social Goals, Following Similar Moves by Jana, BlackRock*, CNBC (Jan. 19, 2018), https://www.cnbc.com/2018/01/19/jeff-ubbens-valueact-launching-fund-with-social-goal.html (describing ValueAct Capital's early 2018 launch of a fund "focused on providing environmental and social goals for the companies it invests in").

[697] David Benoit, *Wall Street Fighters, Do-Gooders — And Sting — Converge in New Jana Fund*, WALL ST. J. (Jan. 7, 2018), https://www.wsj.com/articles/wall-street-fighters-do-goodersand-stingconverge-in-new-jana-fund-1515358929.

[698] *Id.*

conducted in partnership with the pension fund California Teachers' Retirement System ("CalSTRS") and targeted the world's most valuable publicly traded company, Apple. This campaign raised concerns regarding the psychological damage to children and teenagers of too much "screen time."[699] In a public letter to Apple, the activists demanded stronger parental controls on devices such as the iPhone.[700] In response, Apple unveiled a new "screen time" feature on its devices less than six months later.[701]

Around the same time, in January 2018, another ESG campaign was initiated by ValueAct Capital's newly launched Spring Fund at international power producer AES. This involved ValueAct founder Jeffrey Ubben joining the board of AES in order to provide support to the company to increase its focus on renewable energy and sell its legacy coal assets.[702] Ubben noted that the Spring Fund was built on the premise "that there is not just a societal good to be done, but excess return to be captured in identifying and investing in businesses that are emphasizing and addressing environmental and societal problems."[703] In June 2020, Jeffrey Ubben announced that he would leave ValueAct to launch Inclusive Capital Partners, a new environmentally and socially-focused hedge fund.[704] This firm is expected to grow well beyond the Spring Fund in terms of assets under management. Prior to the shift, ValueAct Capital Partners had assets under management of around $16 billion, with the Spring Fund making up $1 billion.[705] The separation of the Spring Fund from ValueAct provides some preliminary evidence of ESG hedge fund activism

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[699] *See* Attracta Mooney, *Activists Don Sustainability Cloak to Whip up Support*, FIN. TIMES (May 13, 2018), https://www.ft.com/content/b74d2adc-2b8e-11e8-97ec-4bd3494d5f14.

[700] Anne Sheehan, *Letter from JANA Partners & CalSTRS to Apple, Inc.*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 19, 2018), https://corpgov.law.harvard.edu/2018/01/19/joint-shareholder-letter-to-apple-inc/.

[701] Sarah Perez, *Apple Unveils New Screen Time Controls for Children*, TECHCRUNCH (June 4, 2018), https://techcrunch.com/2018/06/04/apple-unveils-new-screen-time-controls-for-children/.

[702] Mark Chediak & Scott Deveau, *This Activist Is Taking a Stake in a Power Generator to Push for Clean Energy*, BLOOMBERG (Jan. 17, 2018), https://www.bloomberg.com/news/articles/2018-01-17/activist-valueact-takes-aes-stake-in-push-for-cleaner-energy (noting that Ubben would work with AES on the company's plan to sell coal assets, reduce debt and develop more solar power and battery storage).

[703] Faber, *supra* note 696 (citing a letter from Ubben to ValueAct's limited partners).

[704] Billy Nauman, *Jeff Ubben Quits ValueAct for Social Investing*, FIN. TIMES (June 23, 2020), https://www.ft.com/content/eaa28471-e295-44a9-a138-dda047db6d1c.

[705] *Id.* (quoting Jeffrey Ubben, who stressed that having an impact fund and a traditional fund under the same roof at ValueAct was "confusing" for investors, as the two strategies could not peacefully coexist — those who opted for the impact vehicle worried they were leaving returns on the table, and those who opted for the flagship fund worried about being portrayed as environmentally or socially "unconscious").

progressing from being a niche subset of an established activist hedge fund's activities to an ESG hedge fund in its own right.

There is also evidence of formidable activists such as Elliott Management — who previously attracted condemnation for setting back ESG issues — focusing on ESG as part of its business model. In 2018, Elliott created a new role of head of investment stewardship[706] and in 2020 the hedge fund reached an agreement with the S&P 500 power supplier, Evergy Inc, to execute a five-year operational "sustainability transformation plan" aimed at speeding up the company's transition to clean energy, which lagged behind peers.[707] In keeping with the tactics used in *Activism 2.0*, Elliott appointed two representatives to Evergy's board. In a complete turnaround from the types of activities that were berated in *Activism 1.0*, Elliott even urged Evergy to suspend share buybacks.[708]

However, the real tipping point — which potentially marks a new era of ESG hedge fund activism — was Engine No. 1's successful proxy contest at ExxonMobil in 2021. Engine No. 1 is an impact hedge fund. It officially launched in December 2020 with a mission to "invest in companies that make money while also investing in jobs, workers, communities, and the environment."[709] The founding members of the firm include former executives from the activist hedge fund Jana Impact Capital and from BlackRock.[710] The fund's inaugural activist campaign was a particularly ambitious move to nominate four independent director candidates to the board of directors of the world's largest listed oil company, ExxonMobil, at the 2021 annual meeting of shareholders.[711] The shareholder vote at Exxon was entirely unprecedented as Engine No. 1's proxy contest was the first

[706] Cara Lombardo, *Elliott Management Goes on Charm Offensive*, WALL ST. J. (Oct. 8, 2018), https://www.wsj.com/articles/elliott-management-goes-on-charm-offensive-1538991001.
[707] Press Release, Evergy, Evergy Announces 'Sustainability Transformation Plan' (Aug. 5, 2020), https://investors.evergy.com/news-releases/news-release-details/evergy-announces-sustainability-transformation-plan.
[708] Nikitha Sattiraju, *Elliott Puts More Stress on ESG*, THE DEAL (Sept. 28, 2020), https://www.thedeal.com/activism/elliott-puts-more-stress-on-esg/.
[709] Svea Herbst-Bayliss, *Hedge Fund Veteran Launches Impact Firm with Former Jana, BlackRock Executives*, REUTERS (Dec. 1, 2020), https://uk.reuters.com/article/us-investment-funds-james/hedge-fund-veteran-launches-impact-firm-with-former-jana-blackrock-executives-idUSKBN28B6AO.
[710] *Id.*
[711] Svea Herbst-Bayliss & Gary McWilliams, *Exxon Faces Proxy Fight Launched by New Activist Firm Engine No. 1*, REUTERS (Dec. 7, 2020), https://uk.reuters.com/article/exxon-shareholders-engine-no-1/exxon-faces-proxy-fight-launched-by-new-activist-firm-engine-no-1-idUKKBN28H1IO.

boardroom battle to focus on the issue of climate change. The campaign and its implications are discussed further in Part IV below.

In summary, this Part has tracked the evolution of activist hedge fund campaigns from short-term financial activism to longer-term operational and strategic activism (achieved through activist board representation) and finally to the recent emergence of new ESG hedge funds launching ESG campaigns. Section II more fully analyzes the role ESG hedge funds can play as ESG arbitrageurs in the sustainable capitalism framework.

II. ESG HEDGE FUNDS AS ESG ARBITRAGEURS

In *Activism 2.0*, activist hedge funds amassed considerable expertise nominating specialist directors to corporate boards. In the ESG context, the same tactics can be used by ESG hedge funds to nominate specialist ESG directors — such as those with renewable energy or climate transition expertise — to boards. The Engine No. 1 proxy contest at Exxon vividly illustrates the unique role that ESG hedge funds can play as ESG arbitrageurs in the sustainable capitalism context. Like the role activist hedge funds played as governance arbitrageurs in the agency capitalism framework, ESG hedge funds can effectively mitigate the rational reticence of the Big Three in the sustainable capitalism framework. In fact, the effect in the ESG context may prove to be even stronger, due to the bold public commitments that the Big Three have made to sustainable capitalism.[712]

A. Activist Hedge Funds as ESG Arbitrageurs

When describing the agency capitalism framework, Gilson and Gordon outlined that a "happy complementarity"[713] could be achieved where "responsibility to beneficial owners for maximizing performance is split between specialists: Activist investors specialize in monitoring portfolio company strategy and formulating alternatives when appropriate for presentation to the institutional investors; in turn, institutional investors specialize in

[712] BlackRock, in particular has been vocal in committing to sustainable capitalism. For example, in his 2020 Letter to CEOs, Larry Fink proposed "achieving a more sustainable and inclusive capitalism," 2020 Letter from Larry Fink, *supra* note 517, and in his 2021 Letter to CEOs, Fink asked companies to disclose a plan for how their business model will be compatible with a net zero economy, Fink, *supra* note 478.

[713] Gilson & Gordon, *Agency Capitalism*, *supra* note 466, at 898 (noting that the "happy complementarity" requires an adequate supply of shareholder activists and thus a high enough return to activists to warrant their efforts).

portfolio management and in evaluating proposals presented by activist investors."[714] This complementarity arose as activist hedge funds could "identify strategic and governance shortfalls with significant valuation consequences" and "present reticent institutions with their value proposition: a specified change in the portfolio company's strategy or structure."[715]

In the agency capitalism framework, activist hedge funds proved to be the "key intermediary".[716] In *Activism 2.0*, they focused on activist board representation, together with detailed, firm-specific, strategic and operational changes. Through these campaign strategies, activist hedge funds became increasingly successful in carving out a governance arbitrageur niche where they filled a monitoring gap that no other actor had the capacity or incentives to fill. The symbiotic relationship between activist hedge funds (as initiators) and institutional investors (as arbiters) that resulted is arguably successful in mitigating rational reticence.

Hedge fund activists and institutional investors were able to co-exist in relative harmony because activist hedge funds adapted their campaigns to align their goals with those of the institutional investors. Simplistically, both activist hedge funds and active mutual funds and pension funds were generally aligned to seek increases in shareholder value. Thus, activist hedge funds could act as governance arbitrageurs to pursue outcomes that were beneficial both for themselves and for shareholders more broadly. Some conflicts in these campaigns did arise with the growth of the Big Three. For example, there were some complaints from the Big Three that activist hedge fund settlements with companies disenfranchised longer-term investors and prioritized short-term gains over long-term value.[717] However, a closer look at *Activism 2.0* campaigns reveals that activist hedge funds adapted their campaigns, potentially to pursue strategies that would enable them to secure

[714] *Id.* at 897. *But see* Coffee, Jackson, Mitts & Bishop, *supra* note 320, at 387-88 (2019) (outlining that a more skeptical view of activism may be necessary because the governance by referendum process does not actually work as simply as described, given the rarity of votes and the prevalence of settlements with activists).
[715] Gilson & Gordon, *Agency Capitalism*, *supra* note 466, at 896.
[716] Coffee et al., *supra* note 714, at 385 (citing Gilson & Gordon, *Agency Capitalism*, *supra* note 466, at 863).
[717] Coffee, *The Agency Costs of Activism*, *supra* note 155, at 14 (noting that the Big Three have all publicly criticized hedge fund activists and board representation settlement processes, suggesting that they perceive themselves to have been excluded from these private agreements); *see also* Kumar & O'Hanley, *supra* note 360 (noting that "a recent rise in settlement agreements entered into rapidly between boards and activists without the voice of long-term shareholders concerns us, as we see evidence of short-term priorities compromising longer-term interests").

the critical support of the institutions. This primarily involved appointing directors to boards and advocating for strategic and operational changes following detailed research on the corporate target. The result was that some of the traditional criticisms of hedge fund activism, such as short-termism, are mitigated to some extent.

As *Activism 3.0* campaigns are in their infancy, it may be difficult to predict exactly how the relationship between ESG hedge funds and pivotal asset managers such as the Big Three will evolve. There are, however, indications that activist hedge funds' transition to ESG has emulated some of the public statements made by the Big Three. Following BlackRock's CEO letters highlighting the importance of ESG, many activist hedge funds released similar statements on their websites regarding their own approach to ESG.[718] Therefore, preliminary evidence suggests that activist hedge funds are again attempting to adapt their strategies to capitalize on the new wave of Big Three interest in sustainable capitalism. By aligning their activism with the priorities of their pivotal voters, activist hedge funds can successfully pursue ESG goals.

The use of *Activism 2.0* strategies in an ESG context is strikingly evident from Engine No. 1's campaign at Exxon. As noted above, this proxy contest was the first of its kind, due to the focus on climate issues. It was also remarkable because Engine No. 1 was not a well-established hedge fund with a formidable reputation for activism. It conducted its audacious campaign with only $250 million in capital, which was supplied by its founder Chris James.[719] By way of contrast, Elliott Management – the biggest activist hedge fund in the United States – manages approximately $48 billion in assets.[720] Even if Engine No. 1 was not a typical activist hedge fund protagonist, Exxon was in many respects an obvious target.[721] Despite its status as an energy behemoth, Exxon stood out for its staggering long-

[718] *See*, *e.g.*, Charles Nathan, *Activists and Socially Responsible Investing*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 31, 2018), https://corpgov.law.harvard.edu/2018/01/31/activists-and-socially-responsible-investing/ (noting that the ESG statement that Trian Partners added to its website in 2017 was similar to the ESG investment policies of the Big Three).

[719] Saijel Kishan, *Hedge Fund Veteran Chris James to Start Impact-Investing Firm*, BLOOMBERG (Dec. 1, 2020), https://www.bloomberg.com/news/articles/2020-12-01/hedge-fund-veteran-chris-james-to-start-impact-investing-firm.

[720] *About Elliott*, ELLIOTT MGMT., https://www.elliottmgmt.com/about-elliott/.

[721] Martin Whittaker & Richard Feloni, '*We Always Believed We Had a Compelling Case for Change' — JUST Interviews Activist Investor Engine No. 1 After Exxon Victory*, JUST CAPITAL (June 2, 2021), https://justcapital.com/news/engine-no-1-discuss-exxonmobil-board-victory/.

term financial underperformance. In 2021, it recorded a $22 billion loss[722] and was removed from the S&P Dow Jones Industrial Average for the first time in almost a century.[723] Financial performance ordinarily translates into unhappy shareholders. However, in Exxon's case, shareholder discontent was much more deeply rooted. The board was notoriously indifferent to the concerns of shareholders and historically refused to engage with its largest investors.[724] Previous prominent *Activism 2.0* campaigns have exposed the risk of disregarding the legitimate concerns of shareholders. A similar approach had already proved fatal to the incumbent management of S&P 500 constituent Darden Restaurants in 2014, enabling the activist hedge fund Starboard Value to succeed in replacing the entire board.[725] Notably, Exxon was also a clear industry laggard with respect to the energy transition. Due to decades of denial and misinformation about the impact of climate change, the company had long been referred to as a "fossil fuel dinosaur."[726] More recently, investors grew uneasy about its outlier status in failing to take any meaningful steps towards energy transition. These factors combined to create the conditions necessary for a perfect storm that resulted in Engine No. 1 ousting three incumbent directors from the board.[727]

Engine No. 1's substantive campaign mainly focused on capital allocation, with the fund urging Exxon to cut investment on projects based on unrealistic oil and gas prices and to focus on growth areas such as renewable energy. The campaign was not limited to operational ESG matters, however, with Engine No. 1 stating that its proposals were designed to help the company secure its dividend for shareholders.[728] Engine No. 1 could not have emerged victorious from its boardroom rebellion alone and its campaign was

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[722] Jennifer Hiller, *Pandemic Pushes Exxon to Historic Annual Loss, $20 Billion Cut in Shale Value*, REUTERS (Feb. 2, 2021), https://www.reuters.com/article/us-exxon-mobil-results-idUSKBN2A21LN.

[723] Eric Platt, *ExxonMobil Booted from the Dow After Close to a Century*, FIN. TIMES (Aug. 25, 2020), https://www.ft.com/content/76ecd406-b08e-4c2c-8643-cd23acb7cf2c.

[724] Justin Baer, Dawn Lim & Cara Lombardo, *Investors Give Exxon Payback for Frustrations on Strategy and Climate*, WALL ST. J. (May 28, 2021), https://www.wsj.com/articles/investors-give-exxon-payback-for-frustrations-on-strategy-and-climate-11622227480.

[725] Stephen Foley, *Starboard Sweeps Away Entire Darden Board*, FIN. TIMES (Oct. 10, 2014), https://www.ft.com/content/1be89158-5086-11e4-9822-00144feab7de.

[726] Terry Macalister, *Shell Chief Delivers Global Warming Warning to Bush in His Own Back Yard*, GUARDIAN (Mar. 12, 2003), https://www.theguardian.com/environment/2003/mar/12/usnews.business.

[727] Jennifer Hiller & Svea Herbst-Bayliss, *Engine No. 1 Extends Gains with a Third Seat on Exxon Board*, REUTERS (June 3, 2021, 1:03 AM), https://www.reuters.com/business/energy/engine-no-1-win-third-seat-exxon-board-based-preliminary-results-2021-06-02/.

[728] Ortenca Aliaj, Derek Brower & Myles McCormick, *ExxonMobil Under Pressure as Church of England Joins Investor Campaign*, FIN. TIMES (Dec. 10, 2020), https://www.ft.com/content/c0639fb0-d81f-4ee9-8d58-d8e8da05c454.

launched with the support of powerful allies. It had strong support from influential institutional investors, including the California State Teachers' Retirement System and other large U.S. pension funds.[729] To successfully elect its dissident slate of nominees, the activist needed to secure the pivotal votes of the Big Three asset managers. In Exxon's case, the Big Three controlled almost 21% of the shares[730] which translated into collective voting power of 31% in the proxy contest.[731] Why did Engine No. 1 – as a 0.02% shareholder – think it could secure the support of the Big Three? Like other institutional investors, the Big Three had expressed frustration with Exxon in the past. As one example, BlackRock lost patience with Exxon in 2016 and voted against key directors due to a board policy that prohibited direct engagement with shareholders.[732] In addition, of course, the Big Three had recently strengthened their public commitments to sustainable capitalism and BlackRock, for example, had warned companies that the asset manager would be increasingly disposed to vote against directors who failed to make sufficient progress on climate change.[733] In this respect, Engine No. 1's campaign was perfectly timed and executed to test the credibility of the Big Three's recent public commitments to sustainable capitalism.

An ESG proxy contest of this nature is completely unprecedented by an activist hedge fund. It draws clear parallels with the activist director campaigns that have become increasingly prevalent, and increasingly successful, at S&P 500 companies in the past decade. Here, the hedge fund is filling an ESG monitoring shortfall that arises from the most pronounced form of rational reticence, namely the Big Three's lack of incentives to initiate firm-specific ESG initiatives. It is unheard of for the Big Three to personally seek to appoint new independent directors to the board who have renewable energy or climate transition expertise or for them to intervene with detailed business plans for the strategy

[729] CALSTRS, STATEMENT ON ALTERNATE BOARD MEMBERS FOR EXXONMOBIL (Dec. 7, 2020) https://www.calstrs.com/statement-on-alternate-board-members-for-exxonmobil; Svea Herbst-Bayliss & Jennifer Hiller, *Tiny Activist Investor's Arguments Against Exxon Draw Crowd to Its Side*, REUTERS (Dec. 11, 2020), https://uk.reuters.com/article/exxon-activist/tiny-activist-investors-arguments-against-exxon-draw-crowd-to-its-side-idUKKBN28L27G.

[730] *See supra* Part I.C, Table 1, at 117.

[731] *See* Exxon Mobil Corporation, Current Report (Form 8-K) (May 26, 2021), https://ir.exxonmobil.com/static-files/6e0b2aef-43eb-4a52-bd34-92b283783b6c.

[732] Ross Kerber, *BlackRock Withheld Support from Two Key Exxon Directors: Filings*, REUTERS (Aug. 29, 2016, 5:03 AM), https://www.reuters.com/article/us-exxon-directors-blackrock-idUSKCN11417F.

[733] 2020 Letter from Larry Fink, *supra* note 517.

and operations of such a major S&P 500 oil and gas company.[734] Firm-specific activism of this nature would clearly fulfil an ESG arbitrageur role in a sustainable capitalism framework by mitigating the most pronounced form of rational reticence.

Engine No. 1's victory at Exxon is therefore a defining moment for ESG hedge fund activism. It illustrates how an activist with an extremely modest stake can campaign on a platform of climate issues to galvanize support from the Big Three and effect major board changes. This case makes it clear that the strategies used in *Activism 2.0* can effectively be used in the ESG context. In particular, the appointment of climate directors — as an analogy to the activist directors who feature prominently in activist hedge fund campaigns in the agency capitalism framework — could prove to be activist hedge funds' unique contribution to mitigating the agency costs of sustainable capitalism.

B. Climate Directors

In the agency capitalism framework, hedge fund activism evolved to the point where the most common strategy of activist hedge funds is now the nomination of minority directors to the board. Institutional investors are often willing to lend their support to campaigns to nominate minority board directors, especially when the nominees are non-affiliated industry experts or turnaround specialists. Institutional investors even, on occasion, request that hedge funds pursue board appointments.[735] It is argued in this Section that it would be especially valuable for ESG hedge funds to emulate these tactics in the sustainable capitalism context. A fruitful course of action would be for activists to nominate climate-focused or specialist energy transition directors to corporate boards, as seen in the Engine No.1 proxy contest. This solution would be targeted at mitigating the firm-specific rational reticence of the Big Three and other asset managers. Making institutional investors the arbiters on ESG board nominees is reminiscent of the proposal made by Gilson and Kraakman in the early 1990s, which envisaged that institutional investors could nominate professional outside directors.[736]

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[734] *See* Bebchuk & Hirst, *Index Funds*, *supra* note 478, at 2098 (noting that "there were approximately 3,800 director nominations at U.S. companies during the twelve-year period from 2007 through 2018 . . . . *not a single nomination* was made by any of the Big Three").

[735] OWEN WALKER, BARBARIANS IN THE BOARDROOM: ACTIVIST INVESTORS AND THE BATTLE FOR CONTROL OF THE WORLD'S MOST POWERFUL COMPANIES 49, 70, 147-48 (2016).

[736] *See* Gilson & Kraakman, *supra* note 558, at 883-84*; see also* text accompanying *supra* note 683.

The only publicized case of a successful ESG campaign by institutional investors themselves nominating a climate expert director to a company board appears to be the case of the Italian energy company Enel, in summer 2020. In this case, the Dutch asset manager Robeco successfully appointed a climate transition expert, Samuel Leupold (the former CEO of Wind Power at Ørsted), to the board of Enel.[737] This campaign was made possible by what Belcredi and Enriques describe as a "peculiar feature of current Italian corporate governance regulation," where minority shareholders can submit a slate of candidates to Italian companies and have the right to have at least one candidate appointed, even where another slate gains a higher number of votes.[738] In this particular instance, the asset manager joined the Executive Committee of Assogestioni which is the representative association of the Italian investment management industry that assists its members to present candidates for election to boards.[739]

As in the *Activist 2.0* cases involving activist board directors, the Big Three are extremely unlikely to nominate climate directors to companies themselves. The Big Three do, however, care about board-related issues. The board of directors is and always has been a key focus for the Big Three. Campaigns to nominate climate directors are therefore precisely the types of campaigns that may be supported by the Big Three, thus serving to mitigate the problem of firm-specific rational reticence. Support might be anticipated from the Big Three for a number of reasons. Firstly, they have made a number of statements regarding the need for board directors to be better educated on climate issues. In 2019, Vanguard stated that companies need to "better educate their boards on climate-risk-related topics."[740] Similarly, State Street noted in 2017 that companies should "ensure that directors have some knowledge, expertise or training on material sustainability or climate

[737] Sophie Robinson-Tillett, *Board Senseless? The Investor Fight Against Climate Incompetence*, RESPONSIBLE INV. (June 11, 2020), https://www.responsible-investor.com/articles/board-senseless-the-investor-fight-against-climate-incompetence (noting that "Samuel Leupold was CEO of Wind Power at DONG Energy, which stood for Danish Oil and Natural Gas, during its transformation into one of the world's largest pureplay offshore wind developers, now named [Ø]rsted" and quoting the Head of Active Ownership at Robeco, Carola van Lamoen, who explained that "the Italian system lends itself to this kind of campaign" but that "'[t]hese moves may be difficult to achieve at a large scale because not all jurisdictions make it possible'").
[738] Massimo Belcredi & Luca Enriques, *Institutional Investor Activism in a Context of Concentrated Ownership and High Private Benefits of Control: The Case of Italy*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER AND ACTIVISM, 386, 393-95 (Jennifer G. Hill & Randall S. Thomas eds., 2015).
[739] Robinson-Tillett, *supra* note 737.
[740] VANGUARD, INVESTMENT STEWARDSHIP 2019 ANNUAL REPORT 22 (2019), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf.

risks facing the company."[741] Secondly, there is a prominent precedent of the Big Three pushing major ESG board-related agendas on the issue of board gender diversity[742] and there are early signs that the Big Three will similarly push for racial board diversity in the near future.[743] The primary case study that supports the thesis that the Big Three may be enthusiastic supporters of proposals by ESG hedge funds to nominate climate directors is the progress made by the Big Three on gender diversity on corporate boards.[744] There is a panoply of evidence to support the contention that the Big Three have been key activists in this portfolio-wide effort at U.S. companies. Undoubtedly the most high-profile, viral, marketing initiative on board gender diversity was State Street's "Fearless Girl" campaign which was launched on International Women's Day in 2017. The Big Three asset manager commissioned a bronze statute to be installed opposite the Wall Street Charging Bull to advertise its new bespoke ESG index fund (denoted by the ticker symbol "SHE") that is dedicated to investing in companies with gender-diverse boards.[745] Barzuza, Curtis, and Webber argue that this campaign should not be dismissed as a marketing gimmick, as it was followed up by concrete action on the part of State Street.[746] The Big Three asset manager pledged to vote against the chair of the nominating committee of boards that lacked any female board representation and failed to improve their record on gender diversity.[747] Ultimately, in 2017, State Street proceeded to vote against directors at 400 of the 476 companies in its portfolio that had no female directors.[748] BlackRock responded in 2018 by going one step further, announcing that it would vote against the entire nominating committee if companies did not show sufficient progress on gender diversity.

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[741] STATE ST. GLOB. ADVISORS, SSGA'S PERSPECTIVES ON EFFECTIVE CLIMATE CHANGE DISCLOSURE 2 (2017), https://www.ssga.com/investment-topics/environmental-social-governance/2017/perspectives-on-effective-climate-change-disclosure.pdf.

[742] *See* Barzuza et al., *supra* note 496, at 1265-69; Gormley et al., *supra* note 505, at 4.

[743] Cyrus Taraporevala, *CEO's Letter on SSGA 2021 Proxy Voting Agenda*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 13, 2021), https://corpgov.law.harvard.edu/2021/01/13/ceos-letter-on-ssga-2021-proxy-voting-agenda/ (noting that in 2021 State Street will vote against the Chair of the Nominating & Governance Committee at companies in the S&P 500 and FTSE 100 that do not disclose the racial and ethnic composition of their boards).

[744] Barzuza et al., *supra* note 496, at 1265-72.

[745] Jenny Rooney, *'Fearless Girl': State Street Global Advisors' CMO on the Rationale, the Controversy and What's Next*, FORBES (Apr. 21, 2017), https://www.forbes.com/sites/jenniferrooney/2017/04/21/fearless-girl-state-street-global-advisors-cmo-on-the-rationale-the-controversy-and-whats-next/.

[746] Barzuza et al., *supra* note 496, at 1266-68.

[747] *Id.* at 1266 (citing Joann S. Lublin & Sarah Krouse, *State Street to Start Voting Against Companies That Don't Have Women Directors*, WALL ST. J. (Mar. 7, 2017), https://www.wsj.com/articles/state-street-says-it-will-start-voting-against-companies-that-dont-have-women-directors-1488862863).

[748] *Id.* at 1248, 1268 (citing Justin Baer, *State Street Votes Against 400 Companies Citing Gender Diversity*, WALL ST. J. (July 25, 2017), https://www.wsj.com/articles/state-street-votes-against-400-companies-citing-gender-diversity-1501029490).

It also stated that it expected firms to have at least two female directors on the board.[749] This seems to be compelling evidence of the Big Three committing to, and competing on the basis of, ESG platforms, especially with respect to board composition and expertise.[750]

These commitments have also been echoed in the climate context. The Big Three have pledged to vote against directors who fail to make meaningful progress on climate change. BlackRock has reiterated that it will vote against directors where companies fail to deal with environmental and social concerns appropriately. Its 2021 voting guidelines state "where we believe companies are not moving with sufficient speed and urgency, our most frequent course of action will be to hold directors accountable by voting against their re-election."[751] In September 2020, BlackRock disclosed that it had voted against fifty-five directors at forty-nine companies for failing to make progress on climate change. The list of those it voted against was focused mainly on energy companies, including S&P 500 constituents ExxonMobil and Chevron.[752] In its 2021 Stewardship Expectations report, BlackRock outlined that in some instances where it had voted against climate risk shareholder proposals for being too prescriptive, it still voted against directors for insufficient disclosure on climate issues.[753] Therefore, there is evidence that the Big Three are willing to vote against directors on ESG issues. Logically, therefore, it seems likely that the Big Three would be willing to support campaigns for the nomination of climate experts to boards, especially given their sustainable capitalist positioning and their expressed willingness to vote against boards that fail to make progress on climate issues.[754]

The Engine No. 1 proxy contest was a test case that illustrates that the Big Three are, in practice, willing to vote against credible candidates who are nominated on a climate

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[749] *Id.* at 1269 (citing Sarah Krouse, *BlackRock: Companies Should Have at Least Two Female Directors*, WALL ST. J. (Feb. 2, 2018), https://www.wsj.com/articles/blackrock-companies-should-have-at-least-two-female-directors-1517598407).
[750] *Id.* at 1269-72.
[751] BLACKROCK, OUR 2021 STEWARDSHIP EXPECTATIONS: GLOBAL PRINCIPLES AND MARKET-LEVEL VOTING GUIDELINES 4 (2021), https://www.blackrock.com/corporate/literature/publication/our-2021-stewardship-expectations.pdf [hereinafter 2021 STEWARDSHIP EXPECTATIONS].
[752] Joanna Partridge, *BlackRock Votes Against 49 Companies for Lack of Climate Crisis Progress*, GUARDIAN (Sept. 17, 2020), https://www.theguardian.com/business/2020/sep/17/blackrock-votes-against-49-companies-for-lack-of-climate-crisis-progress.
[753] BLACKROCK, 2021 STEWARDSHIP EXPECTATIONS, *supra* note 751, at 22-23.
[754] However, *see infra* note 516 regarding BlackRock's backtracking on its previous declarations of environmental responsibility.

platform. Here, the director nominees were energy industry veterans, with backgrounds in traditional and renewable energy, especially energy transition.[755] Three of Engine No. 1's four nominees won seats on Exxon's board, primarily due to the voting choices of the Big Three. The Big Three voting reports revealed that BlackRock voted in favor of three of Engine No. 1's nominees,[756] with Vanguard[757] and State Street[758] each supporting two candidates.

The dramatic success of the closely watched battle at Exxon means that further ESG hedge fund activism is likely to proliferate. However, future campaigns may not need to take the form of high-profile shareholder votes. Again, drawing analogies with *Activism 2.0* campaigns, there were some early high-profile proxy battles, but in later years almost all campaigns were resolved via a settlement between the company and the activists. Excluding Engine No. 1's ESG proxy contest at Exxon, there have only been seven activist board representation campaigns at S&P 500 companies that actually culminated in a shareholder vote.[759] This is perhaps because running a proxy contest for board representation can prove to be incredibly costly, both for the activist and the target company. The average cost of a proxy fight in the U.S. is in excess of $10 million.[760] Engine No. 1 is reported to have spent approximately $30 million on the campaign[761] which was

[755] Herbst-Bayliss & McWilliams, *supra* note 711. The nominees were: Gregory Goff (former CEO of San Antonio-based refiner Andeavor); Kaisa Hietala (former leader of the renewables business of Finnish refiner Neste Oyj); Alexander Karsner (former senior strategist of Alphabet's innovation lab who served in the Energy Department under President George W Bush); and Anders Runevad (former CEO of Danish wind turbine manufacturer Vestas).

[756] BLACKROCK, VOTE BULLETIN: EXXONMOBIL CORPORATION 1 (May 26, 2021), https://www.blackrock.com/corporate/literature/press-release/blk-vote-bulletin-exxon-may-2021.pdf [hereinafter EXXONMOBIL VOTE BULLETIN].

[757] VANGUARD, VOTING INSIGHTS: A PROXY CONTEST AND SHAREHOLDER PROPOSALS RELATED TO MATERIAL RISK OVERSIGHT AT EXXONMOBIL 1 (2021), https://static.vgcontent.info/crp/intl/avw/mexico/documents/inv-stew-voting-insights-exxonmobil.pdf. [hereinafter EXXONMOBIL VOTING INSIGHTS]

[758] Ross Kerber, *Top Exxon Investors State Street, Vanguard Backed Activist Nominees*, REUTERS (May 27, 2021), https://www.reuters.com/business/energy/state-street-backed-two-activist-hedge-fund-nominees-exxon-board-2021-05-27/.

[759] The companies were Forest Laboratories (Icahn Enterprises) in 2011 and 2012, International Game Technology (Ader Group) in 2013, Darden Restaurants (Starboard Value) in 2014, DuPont (Trian Fund Management) in 2015, General Motors (Greenlight Capital Management) in 2017, Procter & Gamble (Trian Fund Management) in 2017 and Automatic Data Processing (Pershing Square) in 2017.

[760] Gantchev, *supra* note 367, at 611 (noting that "[a] campaign ending in a proxy fight has average costs of $10.71 million"). However, it should be acknowledged that most activist hedge fund board representation campaigns — at least with the major activist hedge funds targeting S&P 500 companies — are settled and do not result in a proxy contest or shareholder vote.

[761] Jennifer Hiller & Svea Herbst-Bayliss, *Exxon, Activist Spend Over $65 Mln in Battle for Oil Giant's Future*, REUTERS (Apr. 15, 2021), https://www.reuters.com/business/energy/exxon-activist-spend-over-65-mln-battle-oil-giants-future-2021-04-15/.

almost equal to its $33 million investment in Exxon's shares. Exxon similarly spent at least $35 million in its defense. Given that this campaign demonstrated that even a small fledgling ESG fund could emerge victorious in battle with one of the world's most valuable and powerful corporations, it is likely that future target companies of ESG campaigns may choose to settle with the activist and work more collaboratively. Indeed, there have already been some more subdued examples of ESG activist board representation at S&P 500 companies, including Jeffrey Ubben joining the board of AES in 2018.[762] Elliott Management's campaign at S&P 500 power supplier Evergy is another example as it involved two of Elliott's proposed directors being appointed to the board, and a detailed strategic and operational five-year plan intended to catalyze Evergy's transition to clean energy.[763] Further, in its defense to Engine No. 1's campaign, Exxon announced the addition of three new board directors one of whom was Jeffrey Ubben of Inclusive Capital Partners.[764] This appeared to be an attempt to use the presence of a different ESG activist hedge fund as a form of "white knight" to protect management from further shareholder interference, a concept Brav, Lund, and Rock have labelled "validation capital."[765]

Prior to the Engine No. 1 proxy contest, it may have been thought that ESG hedge funds might exacerbate the rational hypocrisy of the Big Three, as even ESG hedge funds would pursue profit motives that environmental and social goals would need to be balanced against. This could lead some to argue that ESG hedge funds may be more focused on profit, which may contradict the Big Three's professed commitment to sustainable capitalism in the portfolio-wide context. In this regard, if there were no rational hypocrisy on the part of the Big Three, we may have expected the Big Three to vote in favor of all four of Engine No. 1's nominees, in particular the nominees who had experience with renewable energy. However, the "greenest" board nominee in the Exxon proxy contest secured less than 10% of the shareholder vote[766] and was thus the only Engine No. 1 candidate who failed to secure a board seat or any votes from the Big Three. This is perhaps surprising given that the Big Three (as agents of diversified shareholders and

[762] Chediak & Deveau, *supra* note 702.
[763] Sattiraju, *supra* note 708.
[764] Svea Herbst-Bayliss & Jennifer Hiller, *Exxon Names Ubben, Angelakis to Board Amid Investor Pressure for Change*, REUTERS (Mar. 1, 2021), https://www.reuters.com/article/us-exxon-mobil-board-idUSKBN2AT2K0.
[765] Alon Brav, Dorothy S. Lund & Edward B. Rock, *Validation Capital* 1, 8 (N.Y.U. Sch. of L., Law & Econ. Rsch. Paper Series, Working Paper No. 21-06, 2021), https://ssrn.com/abstract=3786161.
[766] *See* Exxon Mobil Corporation, *supra* note 731, at 3.

shareholders who invested in ESG index funds) should be less concerned with idiosyncratic, firm-specific returns and more concerned with portfolio-wide risk and returns. Instead, the votes of the Big Three supported only the candidates with stronger backgrounds in traditional energy and the energy transition.

It is therefore also important to acknowledge that the Big Three's sustainable capitalism — for the moment, at least — has limits. Given that the successful board nominees have strong backgrounds in traditional energy, the extent to which the board overhau1 will transform Exxon's overall business remains to be seen. On their website, Engine No. 1 highlights the achievements of the Exxon board nominees one year later.[767] However, most recent news articles have largely been more cynical as to the practical impact of Engine No. 1's board nominees at Exxon in terms of the company's environmental responsibility or progress towards net zero.[768] What is clear, however, is that there is a growing tendency for activists and institutional investors to view climate risk as a major financial risk and thus ESG as a value-creation opportunity. During the Exxon campaign, Engine No. 1 itself stressed that it is a capitalist group and was upfront that its campaign focused on financial underperformance as well as climate.[769] Given the Big Three's voting behavior in this campaign, the result will have underpinned the importance of ESG activists emphasizing the financial benefits of any campaign, in addition to the environmental or social benefits. As specialist ESG funds will only be incentivized to intervene if climate goals align with the opportunity to capture financial returns, the potential for rational hypocrisy on the part of the Big Three remains.

To conclude, the appointment of climate experts to boards is a key area with a lot of potential for ESG arbitrageurs. It has already been demonstrated how successful the strategy of appointing activist directors has been in the traditional governance arbitrageur scenario and Engine No. 1's campaign at Exxon is the first ESG proxy contest to bear a striking resemblance to classic activist hedge fund tactics seen in *Activism 2.0.* Nominating

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[767] ENGINE NO.1, EXXONMOBIL: ONE YEAR LATER, (May 25, 2022), https://engine1.com/transforming/articles/exxon-mobil-one-year-later/. *See also* Justin Jacobs, *Signs of change at ExxonMobil a year after hedge fund proxy fight*, FIN. TIMES (May 24, 2022), https://www.ft.com/content/54863d07-ac24-436e-bfab-b9c077f56415.

[768] *See, for example*,

[769] Derek Brower, *Hedge Fund That Beat ExxonMobil Says It Will Have to Cut Oil Output*, FIN. TIMES (May 27, 2021), https://www.ft.com/content/52645b30-c378-49e3-8609-4f537284889a.

climate directors could have a meaningful impact on firm-specific corporate sustainability strategies and thus could serve to genuinely promote sustainable capitalism. This is an area where ESG hedge funds could generate support from the Big Three. In fact, gaining Big Three support for ESG campaigns may be easier than securing their backing for more traditional financially oriented campaigns, due to the Big Three's strong public commitments to sustainable capitalism. Assuming the Big Three and other asset managers are not willing to personally take on the role of appointing directors, ESG hedge funds may be the only actors that could realistically afford to pursue such a strategy. The appointment of climate directors is a tactic waiting to be exploited in the ESG activism ecosystem, as the Engine No. 1 proxy contest demonstrates.

III. ESG HEDGE FUND ACTIVISM – CAMPAIGNS

ESG hedge fund activism is still very much an evolving phenomenon. However, collecting data on the campaigns that have been carried out to date can perhaps provide an indicator of how this form of activism is evolving to date, and which activist funds are likely to be key players in the ESG activism ecosystem.

There are essentially two types of activist hedge funds that engage in ESG activism. The first general type is the major hedge funds whose activities were analyzed in Chapter 4. The second general type is specialist ESG funds that have been established in recent years. There is some crossover between the first type and the second type, as often specialist ESG funds have been set up by former managers of established activist hedge funds that engaged in more traditional forms of activism.

In Chapter 4, we saw that there was a relatively small group of activist hedge funds that were active in seeking and securing activist board representation. These are representative of the biggest and most formidable activist hedge funds in the United States. In this Section III, I will explore the type of activism that these funds have carried out in the ESG space to date. The activities of newly established ESG funds are also important, but this is a matter for future work. As ESG hedge fund campaigns only really began in 2018, there are a limited number of cases to study. However, it seems inevitable that ESG activism will continue to grow, especially given the rise of ESG investing in recent years.

The below table outlines environmental and social activism campaigns by the nine most prominent activist hedge funds in the United States (each of which were responsible for four or more activist board representation campaigns in the dataset presented in Chapter 4). Trian Fund Management,[770] Pershing Square Capital Management and Corvex Management did not appear to have any environmental or socially focused activist campaigns, so are not included in the table.

Table 11: Environmental and Social Activism Campaigns by Prominent Activist Hedge Funds in the United States

	Activist Hedge Fund	Year	Company	Type of E&S Campaign	Activist Campaign Strategy	Successful
1.	Icahn Enterprises	2022	McDonald's Corporation	Social (animal welfare)	Board representation / proxy contest	No
2.	Icahn Enterprises	2022	Kroger Company	Social (animal welfare)	Board representation / proxy contest	No
3.	Elliott Management	2022	Suncor Energy Inc	Social (workplace safety record)	Board representation / divestiture (gas assets)	Partly - 3 board seats
4.	Elliott Management	2021	SSE	Environmental	Board expertise (renewables) / spin-off (renewables) / strategic & operational	Ongoing
5.	Elliott Management	2020	Evergy	Environmental	Financial (suspend share buybacks) / business strategy (sustainability)	Yes – 4 board seats and "sustainability transformation plan"
6.	Elliott Management	2016	Samsung Electronics	Social (diversity & equality) (minor part of campaign)	Board representation / capital structure / dividends / divestiture	Partly – no board seats but other goals met
7.	ValueAct Capital Partners	2018/ 2020	Hawaiian Electric Industries	Environmental	Business strategy (accelerate renewables)	No (but gained board representation in 2020)

[770] A Cerulli Associates report did, however, note that Trian "has pushed companies including GE, DuPoint, and Danone to promote workforce diversity, adopt supplier codes of conduct, and reduce emissions and waste." *See* Amy Whyte, *Hedge Fund Activists Pivot to ESG*, INST. INV. (Jan. 23, 2020), https://www.institutionalinvestor.com/article/b1k0ztq7n2wc6d/Hedge-Fund-Activists-Pivot-to-ESG.

8.	ValueAct Capital Partners	2018	AES	Environmental	Board representation & business strategy / divestiture (focus on renewables / sell coal)	Yes – 1 board seat
9.	Starboard Value	2022	Huntsman Corporation	Environmental	Board representation (proxy fight) / governance (removal of CEO) Business strategy (operations, environmental strategy & TCFD-aligned disclosures)	No
10.	JANA Partners	2018	Apple	Social (devices screen time)	Operational (business focus)	Yes
11.	Third Point Partners	2021	Shell	Environmental	Divestiture (split refining and renewables)	Ongoing
12.	Third Point Partners	2020	Prudential PLC	Environmental	Operational (cost-cutting), Governance (replace management), Divestiture (spin-off)	Partly – chair replaced

As there have not been many ESG hedge fund activist campaigns as yet by the major activist hedge funds, it can be seen that this is still an evolving strategy without sufficient data to draw meaningful conclusions. Moreover, as explained further in Chapter 7, Icahn's campaigns at McDonald's and Kroger were not-for-profit campaigns.

What has been more prevalent than activism by the major activist hedge funds is environmental and social campaigns by bespoke ESG activist funds. However, that is outside of the scope of this thesis and is discussed briefly as a matter for future work.

Chapter 7 – ESG Activism: For Purpose or for Profit?

I. ACTIVISM FOR PURPOSE OR FOR PROFIT?

In 2021, around the same time as the Engine No. 1 campaign at ExxonMobil, another little-known activist hedge fund activism campaign similarly attracted global attention due to the perceived consequences of the campaign for sustainable capitalism. In France, the food products company Danone and its CEO Emmanuel Faber became the target of a London-based activist hedge fund, Bluebell Capital Partners. The abrupt ousting of Faber — who had long been a vocal advocate of corporate social and environmental responsibility — was lamented as a major blow to capitalism. By contrast, the Engine No. 1 campaign at Exxon Mobil was celebrated as a pivotal moment for environmental and social shareholder activism and sustainable capitalism.

At first sight, these two examples appear to signal completely different implications for the growth of purpose-driven companies and the role that investors might play in promoting sustainable capitalism. The campaign at Exxon inspired hope and the campaign at Danone generated despair. However, on closer examination, the campaigns have much in common. They both serve to illustrate that even environmentally and socially focused investors will typically also be astutely concerned with the financial performance of a target company. The Danone campaign reveals that a strong focus on environmental and social issues will not shield a CEO from being targeted by activists who believe the company is underperforming financially. The Exxon case highlights that if a company performs poorly both financially and with respect to ESG goals, this can lead to activists launching an even stronger two-pronged attack. The ability to campaign on a dual platform of profitability and sustainability can enable activist hedge funds to secure even more widespread support from other investors.

These recent campaigns also raise important questions about ESG activism and purpose-driven companies. To what extent will investors be willing to trade-off financial returns in favor of environmental and social progress? How should companies and their leaders prioritize and balance ESG factors with the pursuit of shareholder wealth maximization? Examining the activist campaigns at Danone and Exxon in this context can perhaps

provide some anecdotal evidence of the balancing act that companies need to undertake and the strategies that activists might use against target companies in the future.

A. Danone: From Topping Milton Friedman to Toppling the CEO

The Engine No. 1 campaign at Exxon has been examined in depth in Chapter 6. In Danone's case, less than a year before Emmanuel Faber's dramatic exit in March 2021, Danone made history by becoming the first publicly traded company in France to adopt a new *société à mission* legal structure.[771] In 2019, France passed a law to enable companies to take greater account of social and environmental issues.[772] Although such companies remain commercial enterprises, they have a defined corporate purpose (*raison d'être*) and are required to pursue social and environmental objectives aligned with that purpose. Companies are accountable to a "Mission Committee" that is responsible for monitoring the progress made towards achieving these objectives.[773] In June 2020, following a shareholder vote where 99.4% of shareholders voted in favor of the necessary bylaw amendment to transform Danone into a *société à mission*, Faber congratulated investors, proclaiming "You have toppled the statue of Milton Friedman here today".[774] Here, Faber was referring to Friedman's famous 1970 New York Times essay, *The social responsibility of business is to increase its profits*,[775] which has long been associated with (or blamed for) the blinkered focus on shareholder wealth maximization in corporate America.[776] Shortly thereafter, it was Faber himself who was toppled. In January 2021–less than seven months after the momentous shareholder vote–the activist hedge fund Bluebell Capital campaigned to replace him as CEO, and on 15 March 2021 Faber was removed both as CEO and chairman.[777] In the media coverage that ensued, the outcome was viewed as

[771] Leila Abboud, *Danone adopts new legal status to reflect social mission*, FIN. TIMES (June 26, 2020), https://www.ft.com/content/1eff9241-ef11-4a38-8b5c-bb825fa108ca. Earlier in 2018, Danone's largest subsidiary, Danone North America, had become the world's largest Public Benefit Corporation.
[772] The PACTE Act no. 2019-486 encouraged socially responsible business by creating 'mission businesses' (*société à mission*).
[773] DANONE, SOCIÉTÉ À MISSION, https://www.danone.com/about-danone/sustainable-value-creation/danone-entreprise-a-mission.html#Framework.
[774] Abboud, *supra* note 771.
[775] Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, (Sept. 13, 1970), https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html.
[776] Brian R. Cheffins, *Stop Blaming Milton Friedman!*, 98 WASH. L. REV. 1, 1607, 1608-1609 (2021).
[777] Leila Abboud, *Danone board ousts Emmanuel Faber as chief and chairman*, FIN. TIMES (Mar. 15, 2021), https://www.ft.com/content/8e7ae718-eb18-4d2f-bd18-59e6349540f2.

detrimental to sustainable capitalism and the ESG movement and the ousting of Faber was highlighted as "a case study in the pitfalls of purpose".[778]

In direct contrast to the media coverage that the Danone case attracted, Engine No. 1's success at Exxon was heralded as an example of the perils of failing to pursue sustainability, with reports noting that the case represented a "sea change in the climate battle" and an indication that "investors are increasingly using their clout to bring carbon-intensive businesses into line on climate change".[779] Although Danone and Exxon are very different companies with completely divergent approaches to sustainability, the shareholder activist campaigns they encountered did have some similarities. For example, both companies were targeted by fledging activist hedge funds, rather than the formidable, established players that were responsible for the majority of the S&P 500 campaigns discussed in Chapter 4. London-based Bluebell Capital Partners is an activist hedge fund focused on investing in European medium-large cap companies.[780] It was launched in November 2019 and manages around €70 million in assets. Bluebell's asset base primarily comprises the founder's own funds and that of friends and family.[781] Similarly, San Francisco-headquartered impact hedge fund Engine No. 1 was officially formed in December 2020 and was only weeks old when it announced its inaugural campaign at Exxon.[782] It launched with initial capital of around $250 million that was largely comprised of founder Chris James' own funds.[783] By way of comparison, Elliott Management–the biggest activist hedge fund in the U.S.–was founded in 1977 and currently manages approximately $55.7 billion in assets.[784]

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[778] The editorial board, *Danone: a case study in the pitfalls of purpose*, FIN. TIMES (Mar. 18, 2021) https://www.ft.com/content/668d9544-28db-4ad7-9870-1f6671623ac5.
[779] Justin Jacobs & Anjli Raval, *Defeats for Big Oil mark 'sea change' in climate battle*, FIN. TIMES (May 27, 2021) https://www.ft.com/content/b9e8e721-6d1c-4513-9034-3f6d99d983b8.
[780] Although the hedge fund was launched in 2019, its founders had been working alongside high profile activist hedge funds such as JANA Partners, Elliott Management and Third Point Partners for many years through their advisory business, Bluebell Partners.
[781] Laurence Fletcher & Leila Abboud, *The little-known activist hedge fund that helped topple Danone's CEO*, FIN. TIMES (Mar. 24, 2021) https://www.ft.com/content/dd369552-8491-40a2-b83b-9a1b2e32407a.
[782] Svea Herbst-Bayliss, *Hedge fund veteran launches impact firm with former Jana, BlackRock executives*, REUTERS (Dec. 1, 2020) https://www.reuters.com/article/us-investment-funds-james-idUSKBN28B6AO; Svea Herbst-Bayliss, *Exxon faces proxy fight launched by new activist firm Engine No. 1*, REUTERS (Dec. 7, 2020) https://www.reuters.com/article/exxon-shareholders-engine-no-1-idUSKBN28H1IO.
[783] Saijel Kishan, *Hedge Fund Veteran Chris James to Start Impact-Investing Firm*, BLOOMBERG (Dec. 1, 2020) https://www.bloomberg.com/news/articles/2020-12-01/hedge-fund-veteran-chris-james-to-start-impact-investing-firm#xj4y7vzkg.
[784] ELLIOTT MANAGEMENT, ABOUT ELLIOTT, VOTE, https://www.elliottmgmt.com/about-elliott.

If companies are targeted by hedge funds that have minimal capital, this naturally means that they can only acquire tiny shareholdings in such large companies. Bluebell did not disclose the size of the stake that it held in Danone, but it was less than the 5% threshold that triggers a requirement to file a disclosure with France's market regulator.[785] At the time of the campaign, Danone's market capitalization was €41 billion so even if Bluebell had invested its entire fund in Danone, it would only have held 0.17% of the shares. Given Exxon's size, Engine No. 1 also held an incredibly small percentage of the company's shares – 0.02%. As is true for other hedge fund activist campaigns, a result of their small shareholdings neither Bluebell Capital nor Engine No. 1 could have succeeded in their campaigns alone. Significant levels of support from large (predominantly institutional) investors who hold a much larger proportion of the shares was therefore necessary for these activist hedge fund campaigns to succeed.

Perhaps the most significant similarity between Danone and Exxon–and the one that was most often obscured in the divergent media coverage–is the role that poor financial performance played in each campaign. It is unlikely that either Danone or Exxon would have been successfully targeted by activist hedge funds had they been outperforming their competitors in terms of shareholder wealth maximization. Despite its status as an energy giant, Exxon was in many respects an obvious activist target as its financial underperformance stood out among its industry competitors. In 2021, Exxon recorded a $22 billion loss[786], with commentators describing the company as having "torched billions in shareholder value in the past few years".[787] The company was also removed from the S&P Dow Jones Industrial Average for the first time in almost a century.[788] Although the sustainability issues that formed a major part of Engine No. 1's campaign were the central focus of most of the media coverage, Engine No. 1 was always upfront in emphasizing that their campaign was as much about shareholder value as it was about wider environmental and social values. The hedge fund noted that their "idea was that this was

[785] Leila Abboud, *Activist fund Bluebell Capital takes aim at Danone*, FIN. TIMES (Jan. 18, 2021) https://www.ft.com/content/2df158fb-357a-499a-b51c-025b4f1d5c97.
[786] Jennifer Hiller, *Pandemic pushes Exxon to historic annual loss, $20 billion cut in shale value*, REUTERS (Feb. 2, 2021) https://www.reuters.com/article/us-exxon-mobil-results/pandemic-pushes-exxon-to-historic-annual-loss-20-billion-cut-in-shale-value-idUSKBN2A21LN.
[787] *The little Engine that could: ExxonMobil loses a proxy fight with green investors*, THE ECONOMIST (May 29, 2021) https://www.economist.com/business/2021/05/23/what-a-proxy-fight-at-exxonmobil-says-about-big-oil-and-climate-change.
[788] Platt, *supra* note 723.

going to have a positive impact on the share price"[789] and that the proposals were designed to help the company secure its dividend for shareholders.[790] In essence, Engine No. 1 was "a shareholder crusader for long-term value, not a climate crusader".[791]

Of course, poor financial performance was more obviously associated with Bluebell's intervention in Danone. Danone's financial performance and share price significantly lagged major European rivals Nestlé and Unilever. Bluebell's campaign highlighted the company's "chronic underperformance compared with larger rival Nestlé".[792] The hedge fund noted that Danone's share price had consistently underperformed Nestlé and Unilever, since Faber had been appointed as CEO in October 2014. While Danone's shares increased by 2.7% since Faber's appointment, Nestlé's shares rose by 45% and Unilever's by 72%.[793] Those are striking differences in financial performance, which would concern any shareholder focused on financial returns. Bluebell also pointed out that Nestlé and Unilever were also "extremely committed to sustainability" yet received far superior financial returns.[794]

B. ESG Activism: A Trojan Horse?

Given their small shareholdings, Bluebell and Engine No. 1 needed the support of larger institutional investors to succeed in their campaigns. The Engine No. 1 campaign is a masterclass in how an activist with an incredibly small shareholding can effectively secure powerful support from other shareholders. With only a 0.02% shareholding, the hedge fund clearly could not have succeeded in replacing three directors on Exxon's board without widespread investor support. There seems little doubt that Engine No. 1's focus on sustainability was instrumental in generating the level of investor support that was needed for the ambitious campaign to succeed.[795] In that sense, might ESG issues become

[789] Brower, *supra* note 769.
[790] Ortenca Aliaj, Derek Brower and Myles McCormick, *ExxonMobil Under Pressure as Church of England Joins Investor Campaign*' FIN. TIMES (Dec. 10, 2020) https://www.ft.com/content/c0639fb0-d81f-4ee9-8d58-d8e8da05c454.
[791] *Activist investors are both greening and greying*, THE ECONOMIST (Jun 10, 2021) https://www.economist.com/business/2021/06/10/activist-investors-are-both-greening-and-greying.
[792] Billy Nauman, *Danone sacking shows limits of stakeholder 'smokescreens'*, FIN. TIMES (Mar. 17, 2021) https://www.ft.com/content/5cdf854a-b6d8-4f14-bfb5-b98a0f09c327.
[793] Abboud, *supra* note 785.
[794] Id.
[795] Having said that, the climate campaign was also framed as a "win-win" for sustainability and shareholder value, which makes it difficult to measure how significant the sustainability issue was by itself.

a form of "Trojan horse" that enables activist hedge funds to generate broader investor support for their campaigns? Conversely, if ESG issues are now so important to investors, how did Bluebell succeed in ousting such a progressive CEO of an iconic mission-driven company?

As previously noted, one of the most significant changes to take place in the investment ecosystem in recent years is the explosion in demand for passive investment funds and bespoke ESG investment products.[796] The huge shift in investor attention to sustainability has been accompanied by ESG investor stewardship and engagement, alongside a rise in ESG shareholder activism. In terms of asset manager engagement and stewardship, around the time of Engine No. 1's campaign, BlackRock in particular had strengthened its public commitment to addressing climate change. As such, Engine No. 1's campaign proved to be a public test of the Big Three's commitments to vote against directors who failed to take action with respect to the climate crisis. Engine No. 1 had the support of various other institutional shareholders from the start of its campaign, including from one of America's largest pension funds, the California State Teachers Retirement System (CalSTRS), which was vocal in backing the dissident slate of board members.[797] By April 2021, Engine No. 1 had secured the support of the three of the largest U.S. pension funds, with each announcing that they would vote for all four of the dissident nominees.[798] Ultimately, however, the pivotal voters in any proxy contest at a U.S. S&P 500 company are the Big Three asset managers – BlackRock, Vanguard and State Street. In the Engine No. 1 proxy contest, the Big Three had collective voting power of around 31%, so they had the power to make or break any activist campaign. As a mere 0.02% shareholder, Engine No. 1 relied on its sustainability arguments to boost the success of its campaign.

The Exxon case is a very clear demonstration of how a platform of ESG issues can generate support for an activist campaign. The stewardship activities of big asset managers are slowly becoming more transparent, so during Engine No. 1's highly publicized

[796] Mooney & Mathurin, *supra* note 478 (noting that 2020 "was the year ESG came of age" and that by the end of 2020, total assets in sustainable funds hit a record of almost $1.7 trillion, up 50% over the year).
[797] CALSTRS, *supra* note 729.
[798] Jennifer Hiller and Svea Herbst-Bayliss, *CalPERS to back activist's four director nominees in Exxon board fight*, REUTERS (Apr. 26, 2021) https://www.reuters.com/business/energy/calpers-back-activists-four-director-nominees-exxon-board-fight-2021-04-26/.

campaign at Exxon, the world was watching the Big Three to assess whether they would live up to their public commitments on climate change in practice.

Alongside the highly publicized commitments on the part of asset managers, there has been increased interest in ESG campaigns by activist hedge funds. Activist hedge funds–typically portrayed as villainous actors–may seem unlikely protagonists in global efforts to promote sustainability and responsible capitalism. Historically, such funds have been laser focused on financial returns and have neither promoted sustainability goals, nor launched activist campaigns with environmental or social components. Although investing in ESG index funds has now become a mainstream investment strategy, ESG-focused activist hedge fund campaigns are currently a niche strategy. However, a vocal minority of activist hedge funds have transitioned (to varying extents) to focus on ESG activism. The formation of such bespoke funds began in January 2018, when two formidable activist hedge funds, Jana Partners and ValueAct Capital Partners launched the specialist ESG-focused funds, Jana Impact Capital[799] and ValueAct's Spring Fund,[800] respectively, and the first ESG hedge fund campaigns took place. The Spring Fund led to ValueAct's founder, Jeffrey Ubben, leaving the hedge fund altogether to form a new impact hedge fund, Inclusive Capital Partners.[801] New players like Engine No. 1 were then formed, often involving executives who have left more traditional activist hedge funds.

Coming back to the Trojan Horse analogy, sceptics of ESG hedge fund activism might worry that environmental and social issues are being used by hedge funds to obscure the true financial motivations driving their campaigns. Here, some parallels might be drawn with the way that activist hedge funds sometimes append governance issues to their core campaigns as a tactical means of securing support from institutional investors.[802] It seems clear that activist hedge funds can use ESG platforms to increase the appeal of their overall campaigns to a wider range of other investors. However, these ESG-focused activist funds are upfront about their purpose and business model. Engine No. 1, for example, made

[799] Benoit, *supra* note 697.
[800] Faber, *supra* note 696.
[801] Svea Herbst-Bayliss, *ValueAct's founder Ubben retires from firm, starts new venture*, REUTERS (June 23, 2020) https://www.reuters.com/article/hedgefunds-valueact/valueacts-founder-ubben-retires-from-firm-starts-new-venture-idUKL1N2E01Z3.
[802] Bratton, *supra* note 272, at 1397.

clear that it is "a capitalist group, definitely not a non-profit".[803] Inclusive Capital Partners also grounds its philosophy in the context of sustainability driving superior long-term financial returns.[804]

Engine No. 1's campaign at Exxon demonstrated how effective campaigning on a platform of sustainability can be to gaining the support of powerful institutional investors. What is more curious, perhaps, is how Bluebell managed to succeed in a campaign that challenged Emmanuel Faber, a poster-CEO for sustainability and responsible capitalism. Although Bluebell did not launch a proxy contest like Engine No. 1, they would not have succeeded in their campaign to remove the CEO unless there was considerable institutional investor backing behind the proposal. Given the public pressure on institutional investors to promote ESG issues, and their public pledges to do so, Danone and Faber could have proved to be a risky and misguided activist target for Bluebell.

Notwithstanding the potentially negative implications for the sustainable capitalism and ESG investor movements, Bluebell was reported to have significant investor support at Danone. At the time of the campaign, Danone's shareholding was made up of 78% institutional investors, 44% of which were U.S. based and 50% were European (including U.K.) based.[805] In an interview following the ouster of Faber, Bluebell's co-founder stated that "support by fellow shareholders–also the French ones–was overwhelming".[806] The activist noted that there had been growing shareholder frustration over lackluster performance under CEO Faber's leadership.[807] It was revealed that other investors had been agitating for change in private discussions with Danone since the previous year.[808]

The position of asset managers such as the Big Three was much less visible in Danone's case than it had been in Engine No. 1's campaign at Exxon. With Exxon, it was very clear

[803] Brower, *supra* note 769.
[804] INCLUSIVE CAPITAL PARTNERS (COUNCIL FOR INCLUSIVE CAPITALISM), https://www.inclusivecapitalism.com/organization/inclusive-capital-partners/.
[805] DANONE, INVESTOR RELATIONS, https://www.danone.com/investor-relations/danone-at-a-glance/ownership.html.
[806] INSIGHTIA, SHAREHOLDER ACTIVISM IN EUROPE 2021, https://www.activistinsight.com/research/Insightia_Europe2021.pdf
[807] Fletcher & Abboud *supra* note 781.
[808] Julie Segal, *Inside Artisan's Battle With Danone – And What Critics Got Wrong*, INST. INV. (Mar. 18, 2021), https://www.institutionalinvestor.com/article/b1r0qrdqw3chnm/Inside-Artisan-s-Battle-With-Danone-And-What-Critics-Got-Wrong.

where the Big Three stood with respect to the director nominees. Each of the three asset managers published press releases setting out their position and voting decisions.[809] In 2020 BlackRock had highlighted in an Investment Stewardship Report that it supported Danone designating itself as a *société à mission*.[810] The 2021 BlackRock Investor Stewardship Report, discussing the period when Faber was ousted, describes BlackRock's engagement on that matter in very vague terms.[811] In the latter stewardship report, it is not clear at all whether BlackRock supported the change in leadership at Danone or not. Instead, the report simply notes that BlackRock had a "strong history of engagement with Danone and following recent investor pressure we…met with the then Chairman and CEO Emmanuel Faber in February 2021 to discuss governance and strategic direction."[812] Given the sensitivities of challenging a company that was a model for purpose-driven business, BlackRock and other institutions may have been reluctant to publicly support Faber's ousting, even if they privately supported it. Although some large investors–for example, Artisan Partners–publicly voiced concerns about Danone's leader,[813] other well-known asset managers took a similar approach to BlackRock and were relatively quiet on the topic. This illustrates that it is much easier for asset managers to publicly support a campaign like Engine No. 1's at Exxon, than a campaign like Bluebell's at Danone. Therefore, a two-pronged campaign where ESG issues are highlighted may be the most effective means to enable activist shareholders to generate the highest levels of public support for their proposals.

Finally, even the hedge fund activists themselves were keen to emphasize that they were not dismissing environmental and social goals. In its letter to the board, Bluebell stressed that it supported Danone's "dual economic and social project" but indicated that "under the leadership of Mr Faber, Danone did not manage to strike the right balance between shareholder value creation and sustainability".[814] Contrary to some of the press reports,

[809] BLACKROCK, EXXONMOBIL VOTE BULLETIN, *supra* note 756; VANGUARD, EXXONMOBIL VOTING INSIGHTS, *supra* note 277; Kerber, *supra* note 758.
[810] BLACKROCK INVESTMENT STEWARDSHIP, OUR APPROACH TO SUSTAINABILITY, 23 (Jul. 8, 2020) https://www.blackrock.com/corporate/literature/publication/our-commitment-to-sustainability-full-report.pdf (noting that 'This proposal was supported by more than 99% of the company's shareholders, including BlackRock').
[811] BLACKROCK INVESTMENT STEWARDSHIP, Q1 2021 GLOBAL QUARTERLY REPORT (May 2021) https://www.blackrock.com/corporate/literature/publication/blk-qrtly-stewardship-report-q1-2021.pdf.
[812] BLACKROCK, *supra* note 811, at 17.
[813] Fletcher & Abboud, *supra* note 781.
[814] Leila Abboud, *Danone's test case for sustainable business*, FIN. TIMES (Feb. 24, 2021) https://www.ft.com/content/11fbced1-c682-4506-b62b-933566c0f1f9; Abboud, *supra* note 785.

the activist hedge fund generally insisted that sustainability concerns did not play a major role in their decision to target Danone and Faber.

Overall, an analysis of investor behavior with respect to the campaigns shows that an ESG-oriented campaign can prove to be an effective means of generating widespread institutional investor support, even for a newly created hedge fund with a very small shareholding. However, it is also clear that financial considerations remain key for most investors. A strong commitment to ESG goals will not protect companies from becoming an activist target.

C. The Shareholders Who Want it All: Profit and Purpose

These cases of activist hedge fund campaigns at prominent companies therefore provide significant evidence that shareholders still strongly focus on financial returns, despite growing attention to environmental and social factors. This could prove to be a challenge for companies who try to be more forward thinking and ground-breaking in pushing environmental or social aspirations or companies whose investments in sustainability will not pay off financially until the much longer-term. As seen with Danone, companies that prioritize environmental and social factors over financial return risk becoming a target of activist hedge funds. It was argued that Faber "spent too much time talking up the "mission" and too little energizing the "enterprise"".[815] Therefore, "distractions from the core goal of making a profit can be dangerous".[816]

These lessons are in line with the enlightened shareholder value version of stakeholder theory, namely that corporate leaders should pursue environmental and social goals as a means of maximizing long-term shareholder value.[817] ESG goals are thought of as a means to an end rather than an end in themselves. In the view of shareholders, Danone's CEO veered too far into the territory of prioritizing environmental and social goals as ends in themselves. Such an approach would be more in line with an alternative version of

[815] The editorial board, *supra* note 778.
[816] Id.
[817] Lucian A Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*' (2020) 106 CORNELL L. REV. 91, 108-110 (2020).

stakeholder theory, which goes further and considers stakeholder welfare to be valuable independently of its effect on shareholder value.[818]

These theoretical debates over corporate purpose highlight the key challenges for ESG investing and sustainable capitalism more generally. Are investors willing to make any trade-offs to financial returns to invest in more environmentally and socially responsible companies? Should corporate managers ever prioritize stakeholder interests over shareholder interests?

In their public statements, most companies insist that no such compromise is necessary. For example, in the U.S. a study has shown that almost none of signatories to the stakeholder focused Business Roundtable Statement on the Purpose of a Corporation in 2019[819] expressed any willingness to prioritize benefits to stakeholders over shareholder wealth maximization.[820] The relevant players in ESG investing, engagement and activism similarly insist that the two goals of profit and purpose are not incompatible, and that ESG strategies are win-win. Starting with activist hedge funds, the business model of these funds relies upon them maximizing returns in target companies. Even when funds specifically focus on ESG issues, they will still only be willing to invest in targets where they see potential financial value. The funds themselves are upfront about the focus on a double-bottom line. For example, Jeffrey Ubben has highlighted that the premise of the Spring Fund, launched by ValueAct in January 2018 (and ultimately superseded by a new venture known as Inclusive Capital Partners), was "that there is not just a societal good to be done, but excess return to be captured in identifying and investing in businesses that are emphasizing and addressing environmental and social problems".[821]

The big asset managers whose support is necessary for activist hedge fund campaigns to succeed similarly explain ESG goals as a means to the end of shareholder wealth maximization. In his annual letters to CEOs, BlackRock's Larry Fink consistently

[818] Bebchuk & Tallarita, *supra* note 817, at 114-115.
[819] Business Roundtable, Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans' (Aug. 19, 2019) https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans.
[820] Lucian A Bebchuk & Roberto Tallarita, *Will Corporations Deliver Value to All Stakeholders?* (2022) 75 VAND. L. REV. (forthcoming), https://ssrn.com/abstract=3899421.
[821] Faber, *supra* note 217 (citing a letter from Ubben to ValueAct's limited partners).

emphasizes that "climate risk is investment risk".[822] In his 2022 letter he also stressed 'We focus on sustainability not because we're environmentalists, but because we are capitalists and fiduciaries to our clients' and that 'stakeholder capitalism is all about delivering long-term, durable returns for shareholders'.[823] Action that was taken by the Big Three with respect to increasing the representation of women on boards is also justified on the basis that diversity boosts corporate performance, rather than on any equity or social justice considerations.[824]

More generally, this "win-win" attitude is reflected in the evolution of the concept of corporate social responsibility to the modern-day ESG movement. While corporate social responsibility "was once framed in moral terms as a goal for management irrespective of profit', ESG as a concept is generally argued 'to provide sustainable long-term value or higher risk-adjusted returns for shareholders".[825]

D. The Limits of ESG Activism

It is a matter of academic debate whether an ESG investment strategy is likely to also be accompanied by superior financial performance. ESG funds have often been marketed as performing better financially compared to non-ESG funds.[826] Despite these claims, in some respects ESG index investing goes against key principles of passive index investing such as ensuring maximum diversification. As ESG funds might deviate from the broader market by excluding entire industries, this increases some forms of risk for investors.[827] Indeed, in practice, much of the outperformance of ESG funds has been attributed to the funds being heavily invested in technology stocks such as Alphabet, Apple and Microsoft, which have performed particularly well in recent years.[828] However, in the past year, some other industries have performed better than technology. For example, oil and gas

[822] 2020 Letter from Larry Fink, *supra* note 517.
[823] Letter from Larry Fink, Chairman and Chief Exec. Officer, BlackRock, to CEOs, https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter [hereinafter 2022 Letter from Larry Fink].
[824] *See* Barzuza et al., *supra* note 496, 1277 and Lipton, *supra* note 115, 140.
[825] Lund & Pollman, *supra* note 8, at 2566.
[826] Riding, *supra* note 672.
[827] Armour & Gordon, *supra* note 17, 36 (noting that "the portfolios of diversified shareholders are insulated from the effects of idiosyncratic (firm-specific) risks").
[828] Adrienne Klasa, *Sustainable funds face threat from tech sector turmoil*, FIN. TIMES (Jan. 18, 2022) https://www.ft.com/content/415bcf2a-c9d5-4a1a-90bb-80ac8d3bc43c.

outperformed ESG funds in 2021.[829] This illustrates that the financial success and growth that ESG funds have recently enjoyed is by no means guaranteed in future. "Doing well" may not always align with "doing good". Contrary to the assertions of companies and investors, it would be naïve to suggest that profit and purpose always align. If that were the case, companies and investors would already have ample incentives to act responsibly. There will always be situations where companies and their managers need to decide whether to prioritize shareholders or stakeholders.

Just as ESG investment fund success is not guaranteed, the Danone case shows that strong corporate ESG performance will not prove to be an effective shield for companies that are performing poorly financially. To avoid being targeted by activists, companies should ideally meet the challenges of ensuring short-term and long-term profitability while also focusing on sustainability.

ESG-focused shareholder activism will also most likely continue to concentrate on situations where purpose can in fact boost profit. There are some examples of campaigns that focus purely on environmental or social factors for their own sake, but such campaigns do not form part of activist hedge funds' core investment strategies. For example, Bluebell Capital has a program where it commits to buy one share at one company per year that lags on environmental or social issues, in order to advocate for better ESG performance.[830] As part of this program, Bluebell bought one share (worth around 100 euros) in the Belgian chemicals company Solvay and campaigned to replace the CEO after she failed to put an end to dumping untreated chemical waste into the sea.[831]

Similarly, the much more well-known hedge fund manager Carl Icahn, also recently conducted what might be termed a pure environmental or social activism campaign at the S&P 500 companies McDonald's and Kroger. Icahn only purchased 200 McDonald's shares, worth around $50,000, which was an extremely modest holding for him with no real economic interest in the company. Icahn's campaign focused on the issue of animal

[829] Patrick Temple-West & Kristen Talman, *ESG shares underperform oil and gas in 2021*, FIN. TIMES (Dec. 30, 2021) https://www.ft.com/content/70984a9e-ab65-4905-a2fa-83202e3db68b.
[830] Fletcher & Abboud, *supra* note 781.
[831] Valentina Za & Simon Jessop, *Activist Bluebell urges Solvay's board to oust CEO over sea discharge*, REUTERS (Sept. 15, 2021) https://www.reuters.com/business/sustainable-business/exclusive-activist-bluebell-urges-solvays-board-oust-ceo-over-sea-discharge-2021-09-15/.

welfare. He launched a proxy contest to nominate two director candidates to push McDonald's to stop buying pork from suppliers that house pigs in inhumane gestation crates.

What has become evident from these rare examples of ESG hedge fund activism for purpose rather than for profit is that it can be very difficult for activists to succeed in such campaigns – even activists as formidable as Carl Icahn who (as we have seen) has considerable expertise in conducting proxy contests and negotiating settlements for board representation. Target companies can push back with financial arguments that might appeal to many shareholders. For example, during Carl Icahn's campaign at McDonald's the company highlighted that his proposal would result in an "untenable financial burden".[832] McDonald's also played on the negative rhetoric surrounding activist hedge funds by mocking "Mr Icahn's newfound focus on ESG" which they said was a "thinly veiled, opportunistic attempt to gain relevancy and media exposure in the current environment".[833] This criticism was quite misleading, as Carl Icahn had in fact worked with the Humane Society of the United States as far back as 2011 to engage behind the scenes with McDonald's to put an end to the use of gestation crates. McDonald's had pledged to stop the use of the crates in their supply chain within a decade, and Carl Icahn had held management to that pledge.[834] Ultimately, Carl Icahn lost the proxy contest at McDonald's, after only about 1% of the company's shareholders voted for Icahn's two board nominees.[835] This was a vastly different outcome from Engine No. 1's campaign at Exxon, and Engine No. 1 was an unheard of fund, whereas Carl Icahn is one of the most formidable activist hedge fund managers. Proxy advisors ISS and Glass Lewis both recommended that shareholders vote with management. Each of the Big Three reportedly voted with McDonald's management, although BlackRock was the only asset manager to issue a voting bulletin where it explained its vote, emphasizing the importance of engaging

[832] Svea Herbst-Bayliss, *McDonald's calls Icahn demands on sourcing pigs unfeasible, expensive*, REUTERS (Apr. 21, 2022) https://www.reuters.com/business/mcdonalds-calls-icahn-demands-sourcing-pigs-unfeasible-expensive-2022-04-21/.

[833] McDonald's Corporation Form DEFA14A, Securities and Exchange Commission, https://sec.report/Document/0001104659-22-055954/.

[834] Icahn's work with the Humane Society of the United States to campaign to McDonald's was first revealed five years later in a book written by the CEO of the Humane Society. *See* WAYNE PACELLE, THE HUMANE ECONOMY, 38 (2016) (noting that McDonald's made an announcement in 2011 that they had agreed to eliminate crates from their supply but that they would need a phase-in period of around a decade to completely eliminate the crates; the company also did not want the public to know of Icahn's involvement).

[835] Patrick Temple-West, *Carl Icahn loses proxy fight with McDonald's over pig welfare*, FIN. TIMES (May 26, 2022) https://www.ft.com/content/850c5d7c-3303-4a69-9944-077b8990394a.

with companies and highlighting that it always acts in the long-term financial interests of its clients.[836] Icahn also dropped a similar campaign at Kroger in June 2022, after losing the proxy fight at McDonald's.

Bluebell managed to secure some support for its campaign at Solvay, however it still failed to succeed. Institutional investors and proxy advisors were divided on whether to support Bluebell's campaign. CalSTRS and another U.S. pension fund supported Bluebell, but many other institutional investors supported management. Glass Lewis abstained and ISS endorsed management. Unlike the Engine No. 1 campaign, no public statements were made by the Big Three asset managers about the campaign. At Solvay's May 2022 shareholder meeting, there was 92% shareholder support to ratify the board's acts over the previous year. This was down from 99% at the meeting in 2021. This figure does slightly obscure the support Bluebell received from independent shareholders as roughly 30% of Solvay's shares are owned by the holding company Solvac SA, so the proportion of independent shareholders withholding support was close to 18%. In any event, this was not sufficient to achieve the level of support required for Bluebell to succeed. Shareholders also voted to reappoint the CEO whose departure Bluebell had called for.

The noticeable divergence from activist hedge funds' normal investment model to conduct these types of "pro-bono" campaigns could perhaps be seen as an implicit admission that activists do always not expect higher ESG standards to increase profitability. There are various reasons why an activist hedge fund might choose to engage in these types of pro bono campaigns. It could help with visibility and credibility when the fund pursues a for-profit ESG campaign. However, in their core business, activist hedge funds tend to focus on ESG campaigns that can contribute to the "double bottom-line" – where the intervention generates a significant profit as well as being environmentally or socially beneficial.

Nevertheless, preliminary evidence may indicate that activist hedge funds are attempting to adapt their strategies to exploit the fact that asset managers are focusing on sustainable capitalism and other shareholders may care about ESG issues. Aligning their campaigns

[836] BLACKROCK INVESTMENT STEWARDSHIP, VOTE BULLETIN: MCDONALD'S CORPORATION 2 (May 26, 2022), https://www.blackrock.com/corporate/literature/press-release/vote-bulletin-mcdonalds-may-2022.pdf.

with the goals of pivotal voters in a proxy contest–as Engine No. 1 did with Exxon–could result in much higher levels of support for activist campaigns. Ultimately, it seems that ESG focused investors and activists will increasingly support companies that promote environmental and social goals, but only if this does not negatively impact financial performance and shareholder wealth.

II. THE ROLE OF SOCIALLY RESPONSIBLE ACTIVISTS

As we saw in Chapter 6, the role of activist hedge funds as governance arbitrageurs in the agency capitalism framework relied upon the activists identifying strategic or governance shortfalls and presenting reticent institutions with a value proposition to address those corporate failures.[837] A similar unique role could be played by ESG hedge funds as ESG arbitrageurs in the sustainable capitalism framework. This role is based on the ESG hedge funds presenting reticent asset managers with firm-specific sustainability proposals, most prominently through the nomination of specialist directors, such as climate directors. The question that is discussed in this final Part V is the role of other socially responsible activists in the ESG investor ecosystem.

A. Socially Responsible Activists as ESG Arbitrageurs

The monitoring role exploited by ESG activist hedge funds focuses on firm-specific issues. Other socially responsible activists — such as non-profit non-governmental organizations, public pension funds, labor unions and religious organizations — have mainly sought to address portfolio-wide ESG issues. There are a variety of strategies that socially responsible activists use to agitate for positive change in terms of the climate crisis but overwhelmingly the most common mechanism utilized to date has been shareholder proposals. As the Big Three have not, to date, submitted any shareholder proposals,[838] this mechanism could represent a monitoring shortfall or governance gap that socially responsible activists could suitably fill. The Big Three certainly can, and do, lend their voting support to shareholder proposals submitted by socially responsible activists. Therefore, such proposals could mitigate the problem of rational reticence on portfolio-wide sustainability issues. However, one difference with respect to this monitoring

[837] Gilson & Gordon, *Agency Capitalism*, *supra* note 466, at 867.
[838] Bebchuk & Hirst, *Index Funds*, *supra* note 478, at 2040, 2102, 2104-05.

shortfall, and this ESG arbitrageur strategy, is that the rational reticence of the Big Three in the portfolio-wide context is not as strong as it is in the firm-specific context.[839] Indeed, the Big Three sometimes seek to bring about similar changes to those sought by socially responsible activists in shareholder proposals in their private "engagements" with corporate managers.[840] To some extent there might be a conflict between the Big Three and socially responsible activists if the Big Three prefer to engage with companies behind the scenes rather than lend voting support to a public shareholder proposal. There are, in fact, many examples of the Big Three refusing to support shareholder proposals specifically because they are engaging in a dialogue with the company on similar issues. Perhaps in the future this conflict will be less pronounced, particularly since the Big Three have now outwardly committed to supporting more proposals. BlackRock explicitly did so in their 2021 Stewardship Expectations report where they stressed that "[w]e see voting on shareholder proposals playing an increasingly important role in our stewardship efforts around sustainability."[841]

Compared to the strategies and tactics pursued by activist hedge funds, shareholder proposals have sometimes been considered a relatively weak disciplinary tool. Although mutual funds always vote their shares — so the Big Three are compelled to vote on each shareholder proposal submitted by socially responsible activists — most proposals seek relatively standardized commitments. These could include greenhouse gas reduction targets, reports on climate-transition plans and strategies, or disclosure of climate lobbying. Therefore, they largely address the less pronounced portfolio-wide rational reticence problem as opposed to the more pronounced firm-specific rational reticence problem. Sustainability activism has also proven to be a much more laborious process than profit-oriented hedge fund activism, as proposals are often filed multiple years in a row before gaining any traction or securing a commitment from target companies. Given the urgency of the climate crisis, change may not happen rapidly enough.

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[839] *See supra* Parts II.A.i–ii (discussing portfolio-wide and firm-specific rational reticence). For a specific example of rational reticence being less pronounced in the portfolio-wide context, see *supra* note 613.

[840] *See* GLADMAN, *supra* note 662, at 1, 6 (noting that BlackRock, in particular "has a long-stated disinclination to support shareholder proposals, preferring to conduct private engagement with companies and vote against management only when it believes such engagement has been ineffective").

[841] BLACKROCK, 2021 STEWARDSHIP EXPECTATIONS, *supra* note 751, at 7.

Neither the process of submitting shareholder proposals to companies nor the use of such proposals in an environmental or social context are recent innovations. There is a long history of individual investors using the shareholder proposal mechanism for governance interventions at large companies.[842] David Larcker and Brian Tayan explain that the roots of individual shareholder activism in the U.S. go back to the 1930s when the Gilbert Brothers proposed a multitude of shareholder resolutions to try to improve governance standards and accountability across American corporations.[843] These "corporate gadflies" still persistently target companies with shareholder proposals.[844] Some individuals are so ubiquitous that Nili and Kastiel outline that "in 2018 five individuals accounted for close to 40% of all shareholder proposals submitted to S&P 1500 companies."[845] Essentially, corporate gadflies fill a monitoring gap by initiating shareholder proposals that large institutional investors are willing to lend their voting support to, despite lacking strong incentives to submit the actual proposal themselves. These gadflies act as a form of governance arbitrageur, so this method of activism functions in parallel to the role played by activist hedge funds in the agency capitalism framework.[846] Gadflies tend to focus on standardized governance proposals. As the large institutional investors (such as the Big Three) have already "expressed formulaic views on these governance matters in their voting guidelines," the gadflies can "tailor their proposals to the voting guidelines of proxy advisors and large institutional investors."[847]

Environmental and social proposals are similarly not a modern invention. Historically, shareholder proposals have been crucial in raising public awareness on environmental and social issues. In the 1950s, the U.S. Securities and Exchange Commission permitted companies to reject shareholder proposals "of a general political, social, or economic

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[842] *See* Harwell Wells, *Shareholder Power in America, 1800-2000: A Short History*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER AND ACTIVISM, 386, 393-95 (Jennifer G. Hill & Randall S. Thomas eds., 2015) at 22 (noting that "[s]o were born the shareholder 'gadflies,' the best-known being the Gilbert Brothers, Wilma Soss, and Evelyn Davis, who from the 1940s to the 1990s submitted literally hundreds of proposals to a range of companies").

[843] DAVID F. LARCKER & BRIAN TAYAN, GADFLIES AT THE GATE: WHY DO INDIVIDUAL INVESTORS SPONSOR SHAREHOLDER RESOLUTIONS? 1 (2016), https://www.gsb.stanford.edu/sites/default/files/publication-pdf/cgri-closer-look-59-gadlies-at-gate.pdf.

[844] Yaron Nili & Kobi Kastiel, *The Giant Shadow of Corporate Gadflies*, 94 S. CAL. L. REV. 1, 2, 18 (forthcoming 2021), https://ssrn.com/abstract=3520214 (citing *A Political Gadfly*, N.Y. TIMES, May 18, 1936, at 16).

[845] *Id.* at 2.

[846] *Id.* at 32.

[847] *Id.* at 30-31.

nature."[848] However, a 1970 U.S. federal court decision reversed this policy by allowing a shareholder proposal to forbid the sale of napalm by Dow Chemical, and thereafter a flurry of social responsibility proposals were allowed to proceed.[849] Cheffins has highlighted that such proposals were particularly common during the 1970s, where campaigns on issues such as the Vietnam War, pollution and apartheid South Africa grew in prominence.[850] By the 1980s, there were more than 100 socially responsible shareholder proposals a year in U.S. corporations.[851] More recently, similar momentum can be seen in relation to the climate crisis, as a wave of environmentally focused shareholder proposals are submitted to corporations around the world.[852]

The shareholder proposal mechanism varies in different jurisdictions. In the U.S., shareholder proposals are precatory (advisory and non-binding) even if they succeed in securing majority shareholder support. Proposals are legally binding in many other countries, such as the U.K. and most of continental Europe. Compared to the U.S., shareholder proposals remain relatively infrequent in continental Europe.[853]

In the U.S., the Securities and Exchange Commission adopted the so-called "town hall" rule — what is now Rule 14a-8 — in 1942. This required a corporation to include, in its proxy and at its expense, proposals put forward by shareholders, together with a short supporting statement to be voted on at the annual meeting."[854] Until recently,[855] any

[848] Wells, *supra* note 309, at 22 (citing JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE (2003)).
[849] Gillan & Starks, *supra* note 617, at 56 (citing HENRY G. MANNE & HENRY C. WALLICH, THE MODERN CORPORATION AND SOCIAL RESPONSIBILITY (1972)).
[850] CHEFFINS, *supra* note 7, at 124 (citing Donald E. Schwartz & Elliott J. Weiss, *An Assessment of the SEC Shareholder Proposal Rule*, 65 GEO. L.J. 643-44 (1977)) (documenting the shareholder proposals submitted by church groups in the 1970s to influence the activities of U.S. corporations doing business in South Africa); *see* John H. Langbein & Richard A. Posner, *Social Investing and the Law of Trusts*, 79 MICH L. REV. 72, 72 (1980).
[851] Wells, *supra* note 309, at 22 (citing LAUREN TALNER, THE ORIGINS OF SHAREHOLDER ACTIVISM (1983)).
[852] *See* Jonathan M. Gilligan, *Carrots and Sticks in Private Climate Governance*, 6 TEX. A&M L. REV. 179, 191 (2018) (noting that "[t]he last few decades have seen especially rapid growth in the use of shareholder resolutions on ESG issues").
[853] *See generally* Peter Cziraki, Luc Renneboog & Peter G. Szilagyi, *Shareholder Activism Through Proxy Proposals: The European Perspective*, 16 EUR. FIN. MGMT 738 (studying shareholder proposals in eight European countries between 1998 and 2008).
[854] Wells, *supra* note 842, at 22 (noting that "[a]s a means of forcing the corporation to do anything, it wasn't much; shareholders during this era almost always voted with management . . . and even if a proposal had won a majority vote it was merely precatory; management was not required to follow it"); *see* 17 C.F.R. § 240.14a-8 (2021).
[855] SEC. & EXCH. COMM'N, PROCEDURAL REQUIREMENTS AND RESUBMISSION THRESHOLDS UNDER EXCHANGE ACT RULE 14A-8, at 132, https://www.sec.gov/rules/proposed/2019/34-87458.pdf; Press

shareholder holding more than $2,000 in stock or a 1% ownership stake in the company for at least one year had the right to submit a shareholder proposal. Unless the S.E.C. gives permission for the company to exclude the item from consideration,[856] "the company must add the shareholder proposal to the agenda for voting at the next annual or special meeting of shareholders."[857] If a proposal gains majority support (50% or more of the shareholder votes), it will pass, although any such proposal will still only be advisory. The first shareholder proposal filed by an institutional investor to be voted on was in 1986.[858] In the late 1980s and through the 1990s, it was common for public pension funds and other coordinated investor groups to file governance proposals (focusing on issues such as anti-takeover defenses).[859] Initially, very few of these proposals passed, although they were effective in publicizing issues and pressuring the board.[860] Governance proposals continued to increase in momentum and became much more successful over the years.

In the U.S., as well as in other jurisdictions around the world, it is now increasingly common for socially responsible activists to submit shareholder proposals to public companies to agitate for change on environmental or social issues. In 2020, 429 shareholder proposals on environmental, social, and sustainable governance issues were filed at U.S. public companies, with ninety-three of those proposals being environmental ones.[861] Various types of socially responsible activists now submit shareholder proposals

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Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Amendments to Modernize Shareholder Proposal Rule (Sept. 23, 2020), https://www.sec.gov/news/press-release/2020-220 (Rule 14a-8(b) is amended so that a stockholder with at least $2,000 of stock will need to have held the stock for at least three years, a stockholder with at least $15,000 of stock will need to have held the stock for at least two years, and a stockholder with at least $25,000 of stock will only need to have held the stock for at least one year.

[856] Based on a survey of no-action letters submitted during the 2019 proxy season, 40% of shareholder proposals targeted for exclusion by companies were those relating to ESG matters. Of that group, the largest subgroup related to environmental matters, sustainability and climate change. Richard Alsop & Yoon-jee Kim, *Shareholder Proposals 2019 — ESG No-Action Letter Trends and Strategies*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 25, 2020), https://corpgov.law.harvard.edu/2020/03/25/shareholder-proposals-2019-esg-no-action-letter-trends-and-strategies/.

[857] Griffin, *supra* note 615, at 179 (citing 17 C.F.R. § 240.14a-8 (2013)).

[858] ROBERT A. G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 199 (2011) (noting that in 1986, the proposal by the Teachers Insurance and Annuity Association-College Retirement Equities Funds ("TIAA-CREF") to put International Paper's poison pill to a shareholder vote was the first such proposal by an institutional investor to be voted on).

[859] Stuart L. Gillan & Laura T. Starks, *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, J. FIN. ECON. 275, 278 (2000) [hereinafter *Corporate Governance Proposals*]; Gillan & Starks, *Evolution of Shareholder Activism*, *supra* note 617, at 57.

[860] Gillan & Starks, *Corporate Governance Proposals*, *supra* note 859, at 303; Wells, *supra* note 842, at 25 (noting that in 1994 "corporate governance proposals sponsored by institutions received on average almost 30 percent of votes cast").

[861] *See* HEIDI WELSH & MICHAEL PASSOFF, PROXY PREVIEW, HELPING SHAREHOLDERS VOTE THEIR VALUES 1, 5 (2020), https://www.ussif.org/files/Proxy_Preview_2020_

to major companies. Non-profit non-governmental organizations, public pension funds, labor unions and religious organizations feature especially prominently. In the past five years, the four U.S. companies listed in the Carbon Majors top twenty-five corporate and state global emitters (ExxonMobil, Chevron, ConocoPhillips, Shell, and BP)[862] have been targeted by non-profit organizations such as As You Sow and Follow This; public pension funds such as the New York State Common Retirement Fund; sustainable investment funds such as Arjuna Capital; labor unions such as the United Steelworkers of America; and various religious organizations.[863] In recent years some large asset managers have also begun filing or co-filing proposals, which illustrates the overlapping motives of socially responsible activists and large asset managers. For example, in 2019, Legal and General Investment Management — the U.K.'s biggest asset manager, with assets under management of £1.3 trillion[864] — co-filed their first ever shareholder resolution, calling on BP to explain how its strategy was consistent with the Paris Agreement on climate change.[865] Similarly, in 2020 and 2021, BNP Paribas Asset Management (who previously supported and voted in favor of similar resolutions) submitted shareholder proposals to Exxon Mobil and Chevron concerning climate lobbying.[866] The Big Three have not, to date, followed suit.

As noted above, shareholder proposals focusing on governance issues have been increasingly successful in recent decades. From 2006 to 2015, 85% of governance proposals to declassify the board received majority shareholder support.[867] One of the reasons these proposals often succeed is that the voting guidelines of institutional investors are largely uniform on such governance matters. Therefore, it is relatively easy for the filers of such proposals to tailor them to secure maximum votes from the institutions who will ultimately determine the proposal's success or failure. By contrast, during the same time

FIN6.pdf. *See generally* Hirst, *supra* note 661, at 10 (noting that the most common social responsibility resolutions in 2014 related to political contributions and lobbying disclosure, greenhouse gas emissions, climate change and sustainability).

[862] GRIFFIN, *supra* note 487, at 8.

[863] *See Engagement Tracker*, CERES, https://engagements.ceres.org (containing data extracted from the Ceres Engagement Tracker database of shareholder proposals from 2016 to present).

[864] *Our Business*, LEGAL & GEN. INV. MGMT., https://www.lgim.com/uk/ad/about-us/our-business/.

[865] *LGIM Active Ownership Report*, LEGAL & GEN. INVESTMENT MGMT. 1, 29 (Jun. 2020), https://www.lgim.com/uk/en/capabilities/investment-stewardship/active-ownership/.

[866] *See Engagement Tracker*, *supra* note 863.

[867] Larcker & Tayan, *supra* note 843, at 9 (noting the sample included all shareholder resolutions proposed by individual investors at Fortune 500 companies, 2006–2015).

period, 0% of environmental proposals received majority shareholder support.[868] Socially responsible activists initiating environmental and social proposals may face additional barriers, as the voting guidelines of the Big Three and other institutions in relation to these issues are often much less straightforward. In particular, voting guidelines often explain that environmental and social resolutions will be voted on a "case-by-case" basis.[869]

Nevertheless, support for environmental and social resolutions is increasing. Although environmental proposals used to garner little support from shareholders, in the last few years they have attracted a much greater percentage of votes in their favor.[870] The Big Three are undoubtedly some of the most significant arbiters of shareholder proposals, given their substantial voting power in economically significant companies.[871] Before 2017, no climate change related shareholder proposal had ever received majority support at a U.S. company.[872] The first climate change shareholder proposal that secured majority voting support was a proposal submitted to Occidental Petroleum in 2017.[873] The proposal requested that Occidental issue an annual report assessing the impact of climate change on its business. This was also the first time that BlackRock voted in favor of an

[868] *Id.*

[869] Nili & Kastiel, *supra* note 844, at 31 (noting that "institutional investors have more diverse views on environmental and social matters, and many voting guidelines provide asset managers more discretion on proposals relating to such matters. For example, the voting guidelines of Vanguard state that its funds '*will vote* for proposals to declassify an existing board' . . . whereas any proposal regarding environmental and social disclosures will be voted on 'case-by-case . . . [and] evaluated on its merits.'" (citing *Proxy Voting Policy for U.S. Portfolio Companies*, THE VANGUARD GROUP, INC. 10, 16 (Apr. 1, 2020), https://about.vanguard.com/investment-stewardship/portfolio-co{mpany-resources/proxy_voting_guidelines.pdf)).

[870] In 2021, the average voting support for climate resolutions in the U.S. was 51%, a record for these types of shareholder proposal. Fourteen (out of twenty-six) climate resolutions achieved majority support, including at prominent U.S. companies such as Chevron, ConocoPhillips, ExxonMobil, General Electric and Procter & Gamble. *See* Jackie Cook & Lauren Solberg, *The 2021 Proxy Voting Season in 7 Charts*, MORNINGSTAR (Aug. 4, 2021), https://www.morningstar.com/articles/1052234/the-2021-proxy-voting-season-in-7-charts. In addition to proposals that won majority support, eighty-two environmentally focused proposals were withdrawn, presumably because the target company agreed to meet at least some of the demands of the proposer. *See* Hannah Orowitz, Talon Torressen & Michael Maiolo, *An Early Look at the 2021 Proxy Season*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 5, 2021), https://corpgov.law.harvard.edu/2021/07/05/early-insights-to-2021-annual-general-meetings-annual-corporate-governance-review/.

[871] The success of environmental resolutions in the 2021 proxy season was largely attributable to the voting support of the Big Three and other large asset managers. *See* Cook & Solberg*, supra* note 870.

[872] COURTNEY KEATINGE, MAX DARROW, KATELYN ROTH, KATE FLANAGAN & DIMITRI ZAGOROFF, GLASS LEWIS, 2020 PROXY SEASON REVIEW 21 (2020), https://www.glasslewis.com/wp-content/uploads/2020/09/2020-Proxy-Season-Review-Shareholder-Proposals.pdf.

[873] Paul Brest, Ronald J. Gilson & Mark A. Wolfson, *How Investors Can (and Can't) Create Social Value*, 44 J. CORP. L. 205, 225 (2019) (citing Erin Ailworth, *Occidental Shareholders Vote for Climate Proposal*, WALL ST. J. (May 12, 2017), https://www.wsj.com/articles/occidental-shareholders-vote-for-climate-proposal-1494616669).

environmental shareholder proposal that management opposed.[874] This vote followed a shareholder resolution that was filed by socially responsible investors at BlackRock regarding its record on climate change. Crucially, the BlackRock resolution had the support of influential pension funds such as the Seattle City Employees' Retirement System which had $339 million invested in a BlackRock index fund and joined as a co-filer.[875] Following discussions with the filers, "BlackRock promised to improve its focus on ESG when engaging with companies, and the resolution was withdrawn."[876] Very shortly thereafter, BlackRock also supported an environmental proposal at ExxonMobil (after previously voting against certain Exxon directors in 2016).[877] The proposal at Exxon gained support from over 62% of shareholders, including each of the Big Three.[878] In 2020, sixteen shareholder proposals concerning social or environmental issues gained more than 50% of the votes at U.S. companies.[879]

Despite the increasing prevalence and success of climate-oriented shareholder proposals in the U.S., the S.E.C. introduced controversial reforms to the rules on shareholder proposals, which will make it more difficult for socially responsible activists to submit environmental (or social) proposals. Under the new rules, which were introduced in September 2020 and take effect for proposals for meetings from 2022 onwards, shareholders may only submit a proposal if they have held $2,000 of company stock for at least *three* years (the previous requirement being *one* year), or higher amounts for shorter periods of time.[880] Aggregation of holdings for the purposes of satisfying the amended ownership thresholds is now also prohibited.[881] Crucially for environmental and social resolutions, the reforms also revise the levels of shareholder support which a proposal must receive to be eligible for resubmission at future shareholder meetings from 3%, 6%, and

[874] *Id.*
[875] Rissman & Kearney, *supra* note 612, at 10174.
[876] *Id.* at 10175.
[877] Kerber, *supra* note 732.
[878] Diane Cardwell, *Exxon Mobil Shareholders Demand Accounting of Climate Change Policy Risks*, N.Y. TIMES (May 31, 2017), https://www.nytimes.com/2017/05/31/business/energy-environment/exxon-shareholders-climate-change.html.
[879] Patrick Temple-West, *Record Year for Environmental, Social Investor Petitions*, FIN. TIMES (June 9, 2020), https://www.ft.com/content/6dceb82a-1084-40bf-91cb-7cb6100f3992.
[880] Press Release, U.S. Sec. & Exch. Comm'n, *supra* note 855 (Rule 14a-8(b) is amended so that a stockholder with at least $2,000 of stock will need to have held the stock for at least three years, a stockholder with at least $15,000 of stock will need to have held the stock for at least two years, and a stockholder with at least $25,000 of stock will only need to have held the stock for at least one year).
[881] *Id.* (Rule 14a-8(b) amendments).

10% for matters previously voted on once, twice, or three or more times in the last five years to 5%, 15%, and 25%, respectively.[882] When deliberating the reforms, the S.E.C. specifically noted that the proposed amendments to Rule 14a-8(i)(12) could have a greater adverse impact on shareholder proposals relating to environmental and social issues compared to shareholder proposals on governance issues. This is because historically, shareholder proposals on environmental and social issues have tended to receive lower voting support than those on governance issues, and proposals on environmental and social issues are more likely to be resubmitted compared to proposals on governance issues.[883] These rules will to some extent impede the progress of environmental shareholder resolutions, especially resolutions that have repeatedly been submitted to companies. In many cases, resolutions are only successful in generating corporate change after multiple years of submission and activism, therefore this valuable route for socially responsible activists may encounter some more obstacles in future.[884]

B. Climate Directors

Part IV demonstrated that appointing climate directors is one of the most impactful contributions that ESG arbitrageurs can make to mitigate rational reticence on the part of the Big Three. It was argued that ESG hedge funds are in a unique position to further this goal, due to their expertise in appointing activist directors in *Activism 2.0* campaigns. Might socially responsible activists also be able to further this goal?

Responsible activist organizations have followed an alternative route to try and focus boards on climate issues. They have submitted shareholder proposals requesting that companies add climate experts to the board.[885] These proposals might be thought of as a

[882] *Id.* (Rule 14a-8(12) amendments).

[883] *See* SEC. & EXCH. COMM'N, *supra* note 855, at 132.

[884] As one example, a majority (61%) of shareholders at Chevron voted in favor of a climate resolution submitted by Follow This, calling up on the oil major to reduce emissions. *See* Press Release, Follow This, 61% of Chevron Shareholders Support Follow This Climate Resolution (May 26, 2021), https://www.follow-this.org/61-of-chevron-shareholders-support-follow-this-climate-resolution/. Previous proposals calling for reduction in greenhouse gas emissions. Previous proposals for Chevron to adopt greenhouse gas reduction targets submitted by Investor Advocates for Social Justice in 2015 and 2016 had been unsuccessful at shareholder vote.

[885] For example, the New York State Comptroller submitted proposals to companies including Chevron, Freeport-McMoRan, Occidental Petroleum and Transocean, asking them to nominate environmental experts to the board of directors. *Engagement Tracker*, *supra* note 863; *see* Michael Garland & Rhonda Brauer, N.Y.C. Off. of the Comptroller, *Boardroom Accountability*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar.

lower-cost alternative to an actual proxy fight. As detailed in Section A above, ESG shareholder proposals are not new. Strategies of this nature can be traced back to the 1970s when shareholder activists campaigned to add directors to boards to further social and environmental causes.[886] Of particular interest in the context of modern ESG activism is "Campaign GM," an activist campaign highlighted by Cheffins as "the most publicized instance of public interest lobbying by shareholders."[887] In that case, shareholders targeted General Motors and submitted shareholder proposals on topics such as "vehicle emissions, automobile safety, pollution from manufacturing plants and ownership of car dealerships by minority groups."[888] Campaign GM was a very early example of shareholders attempting to add three diverse and environmentally-oriented directors to GM's all-male, all-white board. The shareholder resolution specifically proposed electing three types of individuals – "an environmentalist, an Afro-American, and a female consumer advocate" – to the board.[889] Although the proposal was (like many other proposals of its era) "voted down by an overwhelming majority," GM's 1970 annual meeting was characterized as "the decisive event in the politicization of the corporation."[890] Although Campaign GM was unsuccessful, within three years the company had in fact added "a black community leader, a female bank executive, and an eminent scientist" to the board.[891]

In more recent times, proposals of a similar nature have been filed at fossil fuel companies such as ExxonMobil and Chevron.[892] In 2015 and 2016, a shareholder proposal was submitted to Exxon, calling for a climate expert to be elected to the board. Although the resolution itself did not achieve majority support (instead it won support from investors

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1, 2018), https://corpgov.law.harvard.edu/2018/03/01/boardroom-accountability/ (noting that the Boardroom Accountability Project 2.0, launched in 2017, "ratchets up pressure on companies to improve the quality of their boards of directors, with particular emphasis on diversity of gender and race and on climate competence").

[886] An early example is Honeywell's AGM in 1970, when anti-war campaigners proposed their own director candidates to Honeywell's board. Donald E. Schwartz, *The Public-Interest Proxy Contest: Reflections on Campaign GM*, 69 MICH. L. REV. 419, 423 (1971); *see* Sarah C. Haan, *Civil Rights and Shareholder Activism:* SEC v. Medical Committee for Human Rights, 76 WASH. & LEE L. REV. 1167, 1189 (2019).

[887] CHEFFINS, *supra* note 7, at 124 (citing *Campaign GM,* THE CORPORATION IN A DEMOCRATIC SOCIETY, 89, 89 (1975)).

[888] CHEFFINS, *supra* note 7, at 125.

[889] *Id.*

[890] *Id.*

[891] *Id.*

[892] From 2015 to 2017, the Province of St. Joseph, Capuchin Order filed proposals for Exxon to nominate an environmental expert to their board. From 2011 to 2018, the New York State Comptroller filed proposals for Chevron to nominate an environmental expert to their board. *Engagement Tracker*, *supra* note 863.

with 20.9% of the shares), the following year Exxon capitulated and appointed a climate expert to its board.[893] However, such proposals are relatively rare. Of ninety-three environmental proposals submitted to U.S. companies in 2020, only two requested board committees on climate change.[894] No proposals requested nomination of board members with climate expertise.[895]

One major drawback of the shareholder proposal route is that these campaigns may not go far enough to foster the firm-specific, strategic, and operational change that is achieved when activist hedge funds appoint directors to boards. It can take a long time to secure climate expert board representation by way of the shareholder proposal mechanism. For example, in the case of Chevron, the New York State Comptroller filed shareholder proposals each year from 2011 to 2018 asking the company to nominate an environmental expert to the board.[896] There is also the problem of critical mass; one director with knowledge of, or expertise in, climate change may not be enough to have a meaningful impact or generate lasting change at a fossil fuel company.[897] Commentary has highlighted that "[i]t's worth remembering that there has been a climate scientist on the board of ExxonMobil since 2017 . . . She was appointed by Exxon in response to shareholder concerns over climate, but clearly hasn't satisfied those concerns. It just goes to show, one person isn't enough to change the board."[898] This situation is quite different to the scenario where one activist hedge fund nominee is appointed to a corporate board, as such nominees have the backup of the hedge fund as a "back office," and the enduring threat of further action from the activist hedge fund if sufficient progress is not made. Other

[893] Ed Crooks, *ExxonMobil Appoints Climate Scientist to Board*, FIN. TIMES (Jan. 25, 2017), https://www.ft.com/content/d87ce444-e388-11e6-8405-9e5580d6e5fb (noting that Exxon had appointed Susan Avery, a respected scientist who has worked extensively on climate change, to the board).
[894] The establishment of board committees on climate change were the subject of resolutions at Chevron and ExxonMobil (both filed by Arjuna Capital). *See* Welsh & Passoff, *supra* note 861, at 61.
[895] Only four resolutions requested nomination of experts to boards, and each related to nominating human rights experts (at Alphabet, CoreCivic, Facebook and Twitter, respectively). *See id.*
[896] *Engagement Tracker*, *supra* note 863.
[897] *See* Mark Granovetter, *Threshold Models of Collective Behavior*, 83 AM. J. SOCIOLOGY 1420, 1420 (1978) (explaining that "[m]odels of collective behavior are developed for situations where actors have two alternatives and the costs and/or benefits of each depend on how many other actors choose which alternative"); *see* Rosabeth Moss Kanter, *Some Effects of Proportions on Group Life*, 82 AM. J. SOCIOLOGY 965, 988 (1977) (noting that "[w]omen (or members of any other underrepresented second category) need to be added to total group or organization membership in sufficient proportion to counteract the effects of tokenism"). *See generally* Rosabeth Moss Kanter, *Men and Women of the Corporation Revisited*, MANAGEMENT REVIEW (1977) (demonstrating — in the context of gender diversity — that dominant group members usually control the group which prevents token group members from forming coalitions to create change).
[898] Robinson-Tillett, *supra* note 737.

socially responsible activists have taken more informal action to pressure companies to have a director responsible for climate change, in particular by forming coalitions of investors. Again, it is not clear how effective this is at changing corporate strategy with respect to climate issues. At present, thirty-eight of the forty-five U.S. companies on the Climate Change 100+ focus list, and all nine U.K. companies on the same list, now have a board member or board committee responsible for climate change.[899]

The main impediment to socially responsible activists nominating climate directors in an analogous manner to activist hedge funds is cost. Submitting shareholder proposals works well for socially responsible activists as often these actors are non-profit organizations with comparatively limited funding and resources. Filing a shareholder proposal is relatively inexpensive,[900] especially compared to the costs involved in nominating a director to the board. Although the vast majority of activist board representation campaigns now result in settlement, this is unlikely to be the case for socially responsible activists who would not have the reputational clout or the resources to back up a campaign for a climate director with a credible threat of a proxy contest.[901] Prohibitive cost may ultimately prove to be a barrier for other socially responsible activists pursuing the types of appointments achieved in the Engine No. 1 campaign.

C. Mitigating Rational Hypocrisy

The other important role socially responsible activists may play is in mitigating rational hypocrisy. Since 2003, U.S. based mutual funds are required to publicly disclose their voting policies and to publicly disclose how the fund voted on each resolution voted on at companies.[902] This means that the Big Three's voting records are reported in a publicly

[899] *Management Quality: All Sectors*, TRANSITION PATHWAY INITIATIVE, https://www.transitionpathwayinitiative.org/sectors (containing hand collected data detailing "has the company nominated a board member or board committee with explicit responsibility for oversight of the climate change policy"); *Companies*, *supra* note 566.

[900] Bebchuk, *supra* note 633, at 876.

[901] *See generally* Krishnan et al., *supra* note 508 (noting that the top hedge funds succeed because they acquire a reputation for what the authors label "clout and expertise").

[902] Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564, 6565 (Feb. 7, 2003) (codified at 17 C.F.R. parts 239, 249, 270, 274). This must be reported in an S.E.C. filing on Form N-PX. Investment Company Act of 1940, 17 C.F.R. § 270.30b1-4 (2021); Hirst, *supra* note 661, at 222.

available repository.[903] However, this information is not particularly useful to investors, as it is reported in an inaccessible format and there would be considerable time, effort and costs involved in collating and analyzing the data. Conditions may, therefore, be ripe for rational hypocrisy to thrive. As outlined by Hirst, "investors in mainstream mutual funds are likely to be unaware of the way their funds vote, and that those votes may not be consistent with their own preferences."[904] There is a "collective action problem of voting information gathering"[905] and the result is that the end investors do not have a clear picture of the manner in which their mutual fund votes. This lack of transparency can contribute to the problem of rational hypocrisy, as the Big Three may be more concerned with marketing themselves as good stewards or responsible investors, rather than committing more time and resources into ensuring they vote responsibly and robustly engage on key issues.[906]

The engagement activities of the Big Three have also historically been lacking in transparency. For many years, the Big Three have issued "Investment Stewardship Reports,"[907] which elaborate on the Big Three's behind-the-scenes engagement with companies. The Big Three's stewardship reports contain anecdotal evidence, with selective disclosure of engagements that the Big Three explicitly choose to draw attention to.[908] These stewardship reports mostly operate as a marketing exercise, rather than serving as a comprehensive and honest review of success and failure.

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[903] N-PX filings are available on the S.E.C.'s Edgar database. *Edgar Database*, SEC. & EXCH. COMM'N, https://www.sec.gov/edgar/searchedgar/n-px.htm.

[904] Hirst, *supra* note 661, at 235 (noting that although mutual funds disclose their voting policies, and although funds are required to disclose their actual votes, these policies and voting records are difficult to compare and interpret and thus comparing the approaches of multiple funds would require considerable effort).

[905] *Id.* at 236.

[906] *See* Griffin, *supra* note 615, at 212-16.

[907] *See, e.g.*, BLACKROCK, INVESTMENT STEWARDSHIP ANNUAL REPORT 1 (2020), https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2020.pdf (providing an example of an Investment Stewardship Report); *see also* STATE ST. GLOB. ADVISORS, STEWARDSHIP REPORT 2018-19, at 1 (2019), https://www.ssga.com/library-content/products/esg/annual-asset-stewardship-report-2018-19.pdf; VANGUARD, INVESTMENT STEWARDSHIP: 2020 ANNUAL REPORT 1 (2020), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2020_investment_stewardship_annual_report.pdf.

[908] Griffin, *supra* note 615, at 186-87.

On a voluntary basis, the Big Three have promised to be more transparent with their stewardship activities and voting. BlackRock's Investment Stewardship Group[909] are increasingly publishing voting bulletins on high profile votes. In 2020, their Stewardship Report notes that they published forty-five vote bulletins to August 2020, which was four and a half times as many as they have issued in the past three years combined.[910] To cite an example from October 2020, BlackRock issued a press release explaining its rationale for voting in favor of a shareholder proposal at P&G requiring reporting on its effort to eliminate deforestation.[911] Reports were also issued by BlackRock and Vanguard regarding the Exxon proxy contest.[912]

The U.K. now goes much further than the U.S. in terms of asset manager disclosure.[913] In the 2020 Stewardship Code, there is a new emphasis on disclosure and reporting, with each Principle of the Code being followed by "Reporting Expectations."[914] Of particular relevance to asset managers is Principle 9 on "Engagement" which outlines that signatories to the U.K. Stewardship Code should disclose "the outcomes of engagement that is ongoing or has concluded in the preceding 12 months."[915] The Big Three are all Tier 1 signatures to the U.K. Stewardship Code.[916] This reporting obligation has the

[909] BlackRock advertises that it has the largest global stewardship team in the industry with fifty plus people across eight offices. *See* BlackRock, *Investment Stewardship: Engagement Priorities*, https://www.blackrock.com/corporate/about-us/investment-stewardship#engagement-priorities. However, given the vast number of portfolio companies in BlackRock's portfolio, commentators insist that BlackRock underinvests in stewardship. *See* Bebchuk & Hirst, *Index Funds*, *supra* note 478, at 2050-59, 2076-80.

[910] BLACKROCK, INVESTMENT STEWARDSHIP ANNUAL REPORT (2020), *supra* note 907, at 5.

[911] BLACKROCK, VOTING BULLETIN: THE PROCTOR & GAMBLE COMPANY (Oct. 13, 2020), https://www.blackrock.com/corporate/literature/press-release/blk-vote-bulletin-procter-and-gamble-oct-2020.pdf.

[912] BLACKROCK, EXXONMOBIL VOTE BULLETIN, *supra* note 756; VANGUARD, VOTING INSIGHTS: A PROXY CONTEST AND SHAREHOLDER PROPOSALS RELATED TO MATERIAL RISK OVERSIGHT AT EXXONMOBIL 1 (2021), https://global.vanguard.com/documents/voting-insights-exxon.pdf.

[913] The U.K. Stewardship Code 2020 sets higher standards of engagement and disclosure by asset managers than its predecessor, the Stewardship Code 2012.

[914] *See* FIN. REPORTING COUNCIL, THE U.K. STEWARDSHIP CODE 2020, at 5, https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Final2.pdf.

[915] *Id.* at 17 (describing Principle 9 of the U.K Stewardship Code 2020). Principle 10 also encourages collaborative engagement and similarly outlines that signatories should describe the outcomes of such collaborative engagement. *See* Davies, *supra* note 686, at 22.

[916] *Asset Managers*, FIN. REPORTING COUNCIL, https://www.frc.org.uk/investors/uk-stewardship-code/uk-stewardship-code-statements/asset-managers (listing the asset managers who have published a statement of commitment to the Stewardship Code). Tier 1 signatories "provide a good quality and transparent description of their approach to stewardship and explanations of an alternative approach where necessary." *Id.*

potential to mitigate the problem of rational hypocrisy, as it applies to all engagements and focuses on outcomes. Davies argues that "since the ESG obligations for signatories to the [Stewardship Code] are essentially disclosure obligations, their impact on behavior is likely to be driven by the reputational consequences of reporting."[917] As noted by Katelouzou and Klettner, disclosure through stewardship codes can increase transparency and accountability across the investment chain.[918]

Due to the historical lack of transparency regarding the Big Three's voting policies and engagements, socially responsible activists have targeted the Big Three directly. As previously highlighted, coalitions of shareholders submitted shareholder proposals to BlackRock and Vanguard.[919] Moreover, there are organizations that focus specifically on improving asset manager accountability. These socially responsible activists essentially act as "information intermediaries," enforcing a system of reputational deterrence.[920] One such organization, Majority Action, runs a campaign to hold asset managers accountable on climate votes.[921] Majority Action has produced a number of reports which detail the voting records of the Big Three and other asset managers in an accessible format. This data is much more user-friendly for investors than the official data that asset managers are obliged to disclose regarding their voting.[922] It therefore serves to increase transparency around the Big Three's voting in practice and thus hold the Big Three accountable.

In recent years, organizations such as Majority Action, ShareAction and Morningstar have published reports, rankings, and research on asset manager voting.[923] For example,

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[917] Davies, *supra* note 686, at 147.

[918] Dionysia Katelouzou & Alice Klettner, *Sustainable Finance and Stewardship: Unlocking Stewardship's Sustainability Potential*, *in* GLOBAL SHAREHOLDER STEWARDSHIP: COMPLEXITIES, CHALLENGES AND POSSIBILITIES 1, 23 (Dionysia Katelouzou & Dan W. Puchniak eds., forthcoming), https://ssrn.com/abstract=3578447.

[919] *See* Mooney, *supra* note 514.

[920] RAY SHAPIRA, LAW AND REPUTATION: HOW THE LEGAL SYSTEM SHAPES BEHAVIOR BY PRODUCING INFORMATION 26 (2020) (noting that reputational sanctions are determined by "information intermediaries" and the way these intermediaries screen, frame, certify and diffuse information dictates the effectiveness of reputational deterrence).

[921] *Holding Asset Managers Accountable on Climate Votes*, MAJORITY ACTION, https://www.majorityaction.us/asset-manager.

[922] *See supra* notes 902–904 and accompanying text (detailing that Form N-PX filings with the SEC are not user-friendly).

[923] MAJORITY ACTION, *2019* CORPORATE CLIMATE ACTION, *supra* note 512, at 1; MAJORITY ACTION, *2020* CORPORATE CLIMATE ACTION, *supra* note 657, at 1; Jackie Cook, *How Fund Families Support ESG-Related Shareholder Proposals*, MORNINGSTAR (Feb. 13, 2020), https://www.morningstar.com/insights/2020/02/12/proxy-votes.

ShareAction ranks the seventy-five most influential asset managers worldwide on responsible investment governance, climate change, biodiversity, and human rights.[924] European asset managers consistently top the list, with Robeco, BNP Paribas Asset Management, and Legal and General Investment Management taking the top three spots. Those asset managers are ranked "A–Leaders," which are defined as having "strong management of risks and opportunities, as well as impacts across multiple responsible investment themes."[925] BlackRock ranks 47th, Vanguard ranks 69th and State Street ranks 39th.[926] BlackRock and State Street are both ranked "D–Business as usual," which is defined as "little evidence to suggest adequate management of material responsible investment risks and opportunities."[927] Vanguard is ranked "E–Laggards," which is defined as "evidence suggests poor management of material responsible investment risks and opportunities."[928] These rankings can serve as good marketing for asset managers who genuinely have strong records on sustainability issues. They can also cause reputational damage to asset managers who outwardly purport to prioritize these issues but have poor rankings in practice. Similarly, Majority Action has published blog posts outlining which key climate-related shareholder resolutions would have passed with BlackRock and Vanguard support. In 2019, they publicized that "BlackRock and Vanguard were among the asset managers least likely to support these critical climate-related resolutions," outlining that "at least 16 critical climate votes would have received majority support if both of these asset managers had voted in favor of them."[929]

These publications and reports — by increasing transparency of the Big Three's activities in practice — serve the valuable function of directly addressing the problem of rational hypocrisy. If the Big Three are exposed when their actions do not match their rhetoric and marketing statements, the problem of rational hypocrisy will be mitigated. Therefore, this alternative approach on the part of socially responsible activists can be effective in holding

[924] SHAREACTION, POINT OF NO RETURNS: A RANKING OF 75 OF THE WORLD'S ASSET MANAGERS APPROACHES TO RESPONSIBLE INVESTMENT 4, 10 (2020), https://api.shareaction.org/resources/reports/Point-of-no-Returns.pdf.
[925] *Id.* at 11-12.
[926] *Id.* at 14-17.
[927] *Id.* at 11, 14-15.
[928] *Id.* at 11, 16-17.
[929] Eli Kasargod-Staub & Majority Action, *Climate in the Boardroom*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 7, 2019), https://corpgov.law.harvard.edu/2019/10/07/climate-in-the-boardroom/.

the Big Three to account. Socially responsible activists therefore play a key role in mitigating rational hypocrisy and reducing the agency problems of sustainable capitalism.

Other corporate campaign groups have targeted their activism at BlackRock and other asset managers. For example, "BlackRock's Big Problem" is "a global network of NGO's and social movements that are pressuring asset managers like BlackRock to align their business practices with a climate-safe world."[930] Their website — which likens BlackRock to Goldman Sachs as the "New Vampire Squid," a "global financial giant with its tentacles in major asset classes all over the world"[931] — features a number of articles, reports and campaign strategies highlighting BlackRock's poor record with respect to the climate crisis and other issues.

Despite their massive power, the Big Three nevertheless operate in a delicate equilibrium. On the one hand, they are conscious to mitigate the risk of being subjected to greater regulation if they overreach their power.[932] There are already vocal calls for increased regulation, or break up, of the Big Three due to antitrust issues uncovered in the common ownership literature.[933] Coffee therefore argues that "the threat of political retaliation will incline many institutional investors toward no more than reticent participation in attempts to curb externalities through collective action."[934] On the other hand, the Big Three may be anxious to avoid aggravating investors and society more generally by being perceived as failing to act as responsible stewards. As a result, they care about, and carefully cultivate, their reputation with investors, other institutional shareholders, and the general public. Hill has scrutinized changing attitudes to shareholder power over recent decades, noting that "around the time of the global financial crisis . . . attitudes to shareholder

[930] *About*, BLACKROCK'S BIG PROBLEM, https://www.blackrocksbigproblem.com/about (noting that the initiative partners with other organizations such as Friends of the Earth U.S., Amazon Watch, and Sierra Club).
[931] *Id.* (citing Ellen Brown, *Meet BlackRock, the New Great Vampire Squid*, COMMON DREAMS (June 22, 2020), https://www.commondreams.org/views/2020/06/22/meet-blackrock-new-great-vampire-squid).
[932] Kahan & Rock, *supra* note 588, at 1798.
[933] *See, e.g.*, Azar, Schmalz & Tecu, *supra* note 671, at 1 ("Theory thus predicts that common ownership implies reduced incentives to compete, pushes product markets toward monopolistic outcomes, and implies a deadweight loss for the economy and particularly adverse consequences for consumers."); *see also* Elhauge, *supra* note 671, at 1267 (recommending antitrust enforcement actions to undo anticompetitive horizontal shareholdings and their adverse economic effects); Posner et al., *supra* note 671, at 1 (advocating for the adoption of the Clayton Act against institutional investors); Steele, *supra* note 671, at 7 (discussing the concerns that the three largest participants of the fund industry pose for corporate governance, competition, and financial market stability and exploring policy solutions to address these risks).
[934] Coffee, *supra* note 623, at 41.

power became increasingly ambiguous and polarized.[935] Institutional investors were heavily criticized for failing to use their power effectively to mitigate the effects of the global financial crisis.[936] Similar polarization might be evident in the context of climate change and other ESG issues. As highlighted in Part I above, the Big Three face significant pressure to use their power responsibly to mitigate the effects of the global climate crisis. They risk losing their social mandate if they are perceived as abusing their power. Barzuza, Curtis and Webber have likewise argued that "each index fund faces pressure to make sure it is not perceived as less committed to social values than its competitors."[937] Name and shame campaigns on the part of socially responsible activists draw attention to this delicate balance. Therefore, such activism could prove to be particularly effective in closing the gap between the Big Three's rhetoric and their actions in practice. This has promise for mitigating the problem of rational hypocrisy and thus the agency costs of sustainable capitalism.

Conclusion

In 2020, BlackRock CEO Larry Fink argued that the climate crisis would trigger a "fundamental reshaping of finance."[938] By that stage, a fundamental reshaping of the investor landscape — featuring the incredible rise to power of the Big Three — had already passed the point of no return. In the absence of regulation to break up the Big Three, their future dominance is largely assured. The urgent global problem of the risk caused by the climate crisis is similarly going nowhere. The Big Three's assumed role as sustainable capitalists therefore becomes increasingly important not only for economic reasons, but also for the future of humanity. Chapter 5 sought to map the potential and perils involved in the Big Three assuming this role. It identified and analyzed the dual problem that potentially arises in the context of the Big Three's sustainable capitalism — rational reticence and rational hypocrisy. Rational reticence has long been recognized as afflicting institutional investors. The passive index investing revolution does not solve this problem, and indeed may exacerbate it in some respects. A monitoring shortfall therefore persists. Examining the wide gulf between the Big Three's rhetoric and their corresponding actions

[935] Jennifer G. Hill, *Images of the Shareholder — Shareholder Power and Shareholder Powerlessness*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER AND ACTIVISM, *supra* note 738, at 56.
[936] *Id.*
[937] Barzuza et al., *supra* note 496, at 1304.
[938] Fink, *supra* note 517.

also revealed a potential new problem: rational hypocrisy. These dual problems give rise to what I have called the agency costs of sustainable capitalism. There is a divergence between the Big Three's actions in the climate context and the rational preferences of diversified index investors who represent society as a whole.

Chapter 6 then focused on the potential solutions to these problems by investigating the role different forms of ESG arbitrageurs could play in mitigating these agency costs. Through theory and practical examples, it was argued that ESG hedge funds focusing on firm-specific ESG activism could evolve to play an analogous role in the sustainable capitalism framework to the role that activist hedge funds play in the agency capitalism framework. In particular, ESG hedge funds are uniquely positioned to nominate specialist ESG directors such as climate directors and focus on firm-specific ESG strategies and operations. The role of ESG hedge funds as ESG arbitrageurs could mitigate the rational reticence of the Big Three, as demonstrated by the Engine No. 1 proxy contest at Exxon.

Other socially responsible activists could potentially pursue some of the same strategies, but through the more limited mechanism of shareholder proposals. Socially responsible activists generally lack the financing to take on target companies to the same level that formidable activist hedge funds do. Therefore, as Chapter 7 discussed, their activism is more likely targeted at portfolio-wide, rather than firm-specific, climate issues (albeit there is some overlap). The Big Three already pursue some of these goals themselves through their private engagements with companies, so there may be some conflict. Ultimately, a key role that socially responsible activists can play is to target the Big Three themselves, by holding them accountable and exposing any discrepancies between their words and actions.

Open questions also remain regarding the tradeoffs between purpose and profit in ESG hedge fund activism in particular. As is the case with many other forms of hedge fund activism, there is likely to be continued debate on whether ESG hedge fund activism is socially beneficial.

Future Work

There is considerable additional work that I had hoped to fit in to this thesis that I ultimately did not have the time or space to include. Those ideas provide a foundation for future research on hedge fund activism and related topics. Below I set out some of the ideas that I plan to explore further in order to fully utilize the data I hand collected and to build upon some of the ideas presented in this thesis.

Extending the Dataset

The process for hand collecting the data for this project was incredibly time intensive. The sample collected covered activist campaigns initiated from the beginning of 2010 until the end of 2019, a ten-year period. I sought to study the most recent campaigns in order to contribute to the literature by analyzing the most up-to-date information available on activist hedge fund campaigns. I also measured activist exits until the end of June 2022, to provide an estimation of the investment horizon of many of these activist campaigns. I would have liked to further extend the dataset to include activist campaigns that were initiated up to the end of 2022, to gain an even more up-to-date picture of activist hedge fund tactics. However, the downside of using such recent data is that many of the campaigns are still ongoing and have been exited yet and so this distorts the analysis of activist investment horizons. In the future, I would like to extend the dataset to cover a fifteen-year period.

Beyond Activist Hedge Funds

As noted in the description of the data sample in Chapter 4, I manually filtered out campaigns from my dataset where the activist investor was not an activist hedge fund.[939] In other studies (such as those authored by Greenwood & Schor and Klein & Zur), the activities of other investors were analyzed in addition to activist hedge funds. As hedge fund activist protagonists were responsible for the vast majority of activist board representation campaigns at S&P 500 companies, I did not investigate the other types of investors who were appointing directors to boards. However, it would have been

[939] *See supra* Chapter 4, Section I. B. 3.

interesting to include these other investors and analyze whether the features of their campaigns differed in any way from those of activist hedge funds.

ESG Activism

Chapter 7 briefly explored the ESG activism carried out to date by the major activist hedge funds that were the focus of the empirical study in Chapter 4. However, there has been much more ESG activism carried out by new bespoke ESG-focused hedge funds, compared to the traditional hedge funds. Such impact funds include Engine No. 1, Inclusive Capital Partners,[940] Impactive Capital, Ides Capital and Clearway Capital.[941] Unfortunately, time constraints limited me including these campaigns and creating a more comprehensive taxonomy of ESG activism.

M&A Activism

The process of hand collecting the data on hedge fund activist campaigns at the S&P 500 revealed some interesting cases of M&A activism. In particular, there were several instances where major activist hedge funds were invested in two companies that ultimately merged with each other or attempted some form of M&A transaction. A high-profile example is the widely reported proposed merger of Baker Hughes and Halliburton which ultimately was abandoned due to antitrust concerns. In that case, following the proposed merger announcement, the activist hedge fund ValueAct Capital became one of the largest investors in both companies and pushed for the merger. The U.S. Department of Justice filed a lawsuit alleging that ValueAct purchased these shares with the intent to influence the companies' business decisions, including decisions related to the merger.[942] A $19 million fine was therefore sought for ValueAct's failure to make a timely notification under the Hart-Scott-Rodino Act of 1976 disclosing that it held a position in both companies.[943] Shortly thereafter, ValueAct agreed to pay a record $11 million fine to settle

[940] The new hedge fund launched by Jeffrey Ubben in 2020 upon his retirement from ValueAct.
[941] Clearway Capital is described as "Europe's first dedicated ESG activist fund".
[942] The United States Department of Justice, Justice Department Obtains Record Fine and Injunctive Relief against Activist Investor for Violating Premerger Notification Requirements (Jul. 12, 2016), https://www.justice.gov/opa/pr/justice-department-obtains-record-fine-and-injunctive-relief-against-activist-investor. The highest fine previously paid for an HSR violation was $5.67 million.
[943] Stephen Foley, *US sues ValueAct over Halliburton-Baker Hughes deal*, FIN. TIMES (Apr. 4, 2016), https://www.ft.com/content/ce80f59a-2b33-3fdb-8a8d-0d39b0d61169; Michael Flaherty & Diane Bartz,

the allegations.[944] ValueAct did not hold a seat on the board of either company. But there were also cases in the dataset where activist hedge funds held board seats in companies that proposed to merge. I am keen to undertake an analysis of the cases where activist hedge funds were involved in merger negotiations in this way, whether as investors or also through board seats and to explore the legal issues surrounding this type of M&A activism. Since some commentators have argued that the abnormal returns from activism are largely explained by the ability of activists to force target firms into a takeover,[945] this project may shed light on additional incentives for activists to seek board seats that were not covered in Chapters 3 and 4. This project will draw on the literature on empty voting, but also presents other potential issues due to the rise in activist board representation.

U.S. regulator sues ValueAct over Halliburton-Baker Hughes disclosures, REUTERS (Apr. 4, 2016), https://www.reuters.com/article/us-bakerhughes-m-a-halliburton-valueact-idUSKCN0X11UL.

[944] Diane Bartz, *ValueAct pays $11 million to settle U.S. stock purchase probe*, REUTERS (Jul. 12, 2016), https://www.reuters.com/article/us-valueact-justice-settlement-idINKCN0ZS2B7.

[945] Greenwood & Schor, *supra* note 277, at 364, 374 (noting that "from the perspective of value creation – activists are most successful at creating value when they are able to effect a change in control").

Conclusion

Is activist board representation different from non-board level hedge fund activism? The answer to this question, and the specific ways that activist board representation manifests differently is key to many of the research questions and hypotheses investigated in this thesis. My empirical study reveals information about hedge fund activism at S&P 500 companies that was not previously known or explored in the literature. The finding that activist hedge funds focus much more on substantive strategy and operations when they seek and secure board representation prompts some necessary reflection on the role of the board in the twenty-first century. It suggests that activist hedge funds are filling a gap by providing more engaged and proactive directors than those who currently sit on the monitoring board. Activist hedge fund campaigns clearly illustrate this, as they often specifically highlight the lack of industry expertise of the current directors. The frequency of activist board representation campaigns at America's largest companies suggests that boards will come under increasing pressure to meet higher standards. Indeed, we can already see shareholders and stakeholders demanding more of boards. The focus on activist short-termism may have prevented any meaningful introspection on the redeeming features of activist campaigns. Dismissed as financial engineers, there is a lack of attention paid to the positive aspects of hedge fund activism. The data do not reveal a short-termist approach to the target companies on whose boards activist directors sit. To the contrary, campaigns may result in activist directors contributing substantively to value creation over a much longer investment horizon than is commonly associated with activist hedge fund interventions. More and more of America's largest companies are experiencing the phenomenon of the activist board. What does this mean for boards more generally? Increasing demands on boards, especially in terms of ESG issues, may ultimately lead to a reimagining of the board. Companies and their management teams may continue to discover that further board evolution is required due to activist hedge funds highlighting, and correcting, some of the deficiencies associated with the monitoring board. ESG hedge fund activism is still a relatively new concept, but the way this form of activism evolves may prove crucial to the future of hedge fund activism and the role of the board. If activists continue to appoint climate directors to corporate boards, then there will undoubtedly be further pressure for companies to proactively improve the board to ensure a focus on sustainable value creation.

Appendix A

Activist Board Representation Campaigns (by year board seats sought)[946]

	Company	Year	Activist Hedge Fund	Vote or Settlement	Seats Gained
1.	Take-Two Interactive Software Inc	2010	Icahn Enterprises	Settlement	3
2.	Biogen Inc	2010	Icahn Enterprises	Settlement	2
3.	Genzyme Corporation (now Sanofi Genzyme)	2010	Icahn Enterprises	Settlement	2
4.	Occidental Petroleum Corporation	2010	Relational Investors	Settlement	1
5.	Motorola Solutions Inc	2010	Icahn Enterprises	Settlement	1
6.	Motorola Mobility Holdings Inc	2011	Icahn Enterprises	Settlement	1
7.	JC Penney Company Inc (now Penney OpCo LLC)	2011	Pershing Square Capital Management	Settlement	2
8.	Iron Mountain Inc	2011	Elliott Management	Settlement	2
9.	Electronic Arts Inc	2011	Relational Investors	Settlement	1
10.	Forest Laboratories Inc	2011	Icahn Enterprises	Vote	None
11.	The Clorox Company	2011	Icahn Enterprises	Withdrew	None
12.	Family Dollar Stores Inc	2011	Trian Fund Management	Settlement	1
13.	HP Inc (formerly Hewlett Packard Company)	2011	Relational Investors	Settlement	1
14.	Illinois Tool Works Inc	2012	Relational Investors	Settlement	1
15.	CR Bard Inc	2012	ValueAct Capital Partners	Settlement	1
16.	Yahoo! (now Altaba)	2012	Third Point Partners	Settlement	4
17.	BMC Software Inc	2012	Elliott Management	Settlement	2
18.	Chesapeake Energy Corporation	2012	Icahn Enterprises	Settlement	4
	Forest Laboratories Inc	2012	Icahn Enterprises	Vote	1
19.	Ingersoll Rand plc (now Trane Technologies plc)	2012	Trian Fund Management	Settlement	1
	Motorola Solutions Inc	2012	ValueAct Capital	Settlement	2
20.	Adobe Systems Inc	2012	ValueAct Capital Partners	Settlement	1
21.	ADT Corporation	2012	Corvex Management	Settlement	1
22.	CBRE Group Inc	2012	ValueAct Capital Partners	Settlement	1

[946] In this table, the date the board campaign was launched, rather than the year the seats were granted, has been used in order to capture the withdrawn or unsuccessful campaigns of activist board representation.

23.	International Game Technology plc	2013	Ader Investment Management	Vote	1
24.	Hess Corporation	2013	Elliott Management	Settlement	3
25.	Dell Inc	2013	Icahn Enterprises	Withdrew	None
	Forest Laboratories	2013	Icahn Enterprises	Settlement	1
26.	Microsoft Corporation	2013	ValueAct Capital Partners	Settlement	1
27.	Air Products & Chemicals Inc	2013	Pershing Square Capital Management	Settlement	3
28.	Transocean Ltd	2013	Icahn Enterprises	Settlement	2
29.	Hologic Inc	2013	Icahn Enterprises	Settlement	2
30.	The Williams Companies Inc	2013	Corvex Management Soroban Capital Partners (joint)	Settlement	2
31.	WPX Energy Inc	2013	Taconic Capital Partners	Settlement	1

32.	Compuware Corporation	2014	Elliott Management	Settlement	2
33.	Mondelez International Inc (formerly Kraft Foods)	2014	Trian Fund Management	Settlement	1
34.	eBay Inc	2014	Icahn Enterprises	Settlement	1
35.	Juniper Networks Inc	2014	Elliott Management	Settlement	2
36.	QEP Resources Inc	2014	JANA Partners	Settlement	1
37.	Darden Restaurants Inc	2014	Starboard Value	Vote	12
38.	Allergan plc	2014	Pershing Square Capital Management	Withdrew	None
39.	Walgreens Boots Alliance	2014	JANA Partners	Settlement	2
40.	Interpublic Group of Companies Inc	2014	Elliott Management	Settlement	3
41.	Dow Chemical Company	2014	Third Point Partners	Settlement	4
42.	PetSmart Inc.	2014	JANA Partners	Withdrew	None
43.	Bank of New York Mellon Corporation	2014	Trian Fund Management	Settlement	1
	Juniper Networks Inc	2014	Elliott Management	Settlement	2

44.	MSCI Inc	2015	ValueAct Capital Partners	Settlement	3
45.	DuPont (E.I du Pont de Nemours and Company)	2015	Trian Fund Management	Vote	None
46.	EMC Corporation	2015	Elliott Management	Settlement	2
47.	PepsiCo Inc	2015	Trian Fund Management	Settlement	1
	eBay Inc	2015	Icahn Enterprises	Settlement	1
48.	TEGNA Inc	2015	Icahn Enterprises	Withdrew	None
49.	Zoetis Inc	2015	Pershing Square Capital Management	Settlement	2

			Sachem Head Capital Management (joint)		
50.	MGM Resorts International	2015	Land & Buildings	Withdrew	None
51.	Macerich Company	2015	Land & Buildings	Settlement	2
52.	Conagra Brands Inc	2015	JANA Partners	Settlement	2
	Family Dollar Stores Inc	2015	Elliott Management	Unresolved	None
53.	Qualcomm Inc	2015	JANA Partners	Settlement	3
54.	Citrix Systems Inc	2015	Elliott Management	Settlement	1
55.	Baxter International Inc	2015	Third Point Partners	Settlement	1
56.	Sysco Corporation	2015	Trian Fund Management	Settlement	2
57.	Pentair plc	2015	Trian Fund Management	Settlement	1
58.	Twenty-First Century Fox Inc	2015	ValueAct Capital Partners	Settlement	1
59.	Freeport-McMoran Inc	2015	Icahn Enterprises	Settlement	2
60.	Yum! Brands Inc	2015	Corvex Management	Settlement	1
61.	Advance Auto Parts Inc	2015	Starboard Value	Settlement	3
62.	Autodesk Inc	2015	Sachem Head Capital Partners Eminence Capital Partners (joint)	Settlement	3

63.	Viacom Inc	2016	SpringOwl Asset Management	Withdrew	None
64.	Xerox Corporation (now Xerox Holdings Corporation)	2016	Icahn Enterprises	Settlement	3
65.	Arconic (now Howmet Aerospace Inc)	2016	Elliott Management	Settlement	3
66.	American International Group Inc	2016	Icahn Enterprises Paulson & Co (joint)	Settlement	2
	Yahoo! (now Altaba)	2016	Starboard Value	Settlement	4
67.	United Airlines Holdings	2016	Altimeter Capital Management PAR Capital Management (joint)	Settlement	3
	Xerox Corporation (now Xerox Holdings Corporation)	2016	Icahn Enterprises	Settlement	1
68.	Harris Corporation	2016	JANA Partners	Settlement	2
	The Williams Companies Inc	2016	Corvex Management Soroban Capital Partners (joint)	Settlement	2
69.	Wells Fargo & Company	2016	GAMCO Investors	Settlement	2
70.	Chipotle Mexican Grill Inc	2016	Pershing Square Capital Management	Settlement	2

71.	NRG Energy Inc	2017	Elliott Management	Settlement	2
	Arconic Inc (now Howmet Aerospace Inc)	2017	Elliott Management	Settlement	3
72.	Perrigo Company plc	2017	Starboard Value	Settlement	5
73.	Cognizant Technology Solutions Corporation	2017	Elliott Management	Settlement	3
74.	CSX Corporation	2017	Mantle Ridge	Settlement	5
75.	Bristol-Myers Squibb Company	2017	JANA Partners	Settlement	3
76.	Tiffany & Co	2017	JANA Partners	Settlement	3
77.	Alliance Data Systems Corporation	2017	ValueAct Capital Partners	Settlement	1
78.	General Motors Company	2017	Greenlight Capital	Vote	None
79.	Procter & Gamble Company	2017	Trian Fund Management	Vote & Settlement	1
80.	Pulte Homes Inc	2017	Elliott Management	Settlement	3
81.	Automatic Data Processing Inc	2017	Pershing Square Capital Management	Vote	None
82.	EQT Corporation	2017	D E Shaw Investment Management	Settlement	2
83.	General Electric Company	2017	Trian Fund Management	Settlement	1
84.	Alexion Pharmaceuticals Inc	2017	Elliott Management	Settlement	1
	Xerox Corporation (now Xerox Holdings Corporation)	2017	Icahn Enterprises	Settlement	5

85.	AES Corporation	2018	ValueAct Capital Partners / Inclusive Capital Partners	Settlement	1
86.	Lowe's Companies Inc	2018	D E Shaw Investment Management	Settlement	3
87.	Seagate Technology	2018	ValueAct Capital Partners	Settlement	1
	Pentair plc	2018	Trian Fund Management	Settlement	1
88.	Akamai Technologies Inc	2018	Elliott Management	Settlement	2
89.	Newell Brands Inc	2018	Icahn Enterprises Starboard Value	Settlement	4 3
90.	Navient Corporation	2018	Canyon Capital Advisors	Withdrew	0
91.	Sempra Energy	2018	Elliott Management	Settlement	2
92.	Symantec Corporation (now NortonLifeLock Inc)	2018	Starboard Value	Settlement	4
93.	Campbell Soup Company	2018	Third Point Partners	Settlement	3

94.	Dollar Tree Inc	2019	Starboard Value	Withdrew	None

	MGM Resorts International	2019	Corvex Management	Settlement	1
	Conagra Brands Inc	2019	JANA Partners	Settlement	1
	Navient Corp	2019	Canony Capital Advisors	Settlement	2
	Bristol-Myers Squibb Company	2019	Starboard Value	Withdrew	None
	eBay Inc	2019	Elliott Management Starboard Value	Settlement	1 1
95.	Marriott International	2019	Land & Buildings	Withdrew	None
96.	L Brands Inc	2019	Barington Capital	Settlement	None (special adviser)
97.	Cerner Corporation	2019	Starboard Value	Settlement	4
	Occidental Petroleum Corporation	2019	Icahn Enterprises	Settlement	3
98.	Emerson Electric Company	2019	D E Shaw Investment Management	Settlement	1
99.	Marathon Petroleum Corporation	2019	Elliott Management	Settlement	1

100.	Nielsen Holdings NV	2020	Elliott Management	Settlement	1
101.	LKQ Corporation	2020	ValueAct Capital Partners	Settlement	1

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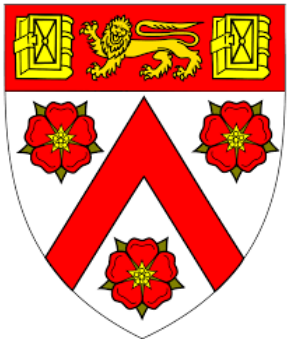
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