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MISSING THE FOREST FOR THE TREES:  
A NEW APPROACH TO SHAREHOLDER ACTIVISM

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# MISSING THE FOREST FOR THE TREES: A NEW APPROACH TO SHAREHOLDER ACTIVISM

YARON NILI<sup>1</sup>

## ABSTRACT

*Shareholder activism has dominated corporate governance literature for the last decade. However, despite the abundance of research focusing on specific manifestations of activism, there is a dearth of literature tackling shareholder activism as a whole. This article puts forward a novel theory situating shareholder activism within a more complete framework, treating activism as a collection of diverse models that differ by motives, tools, and structures. This paper provides a more complete perspective on activism—an analytical understanding of activism as a model rather than an investigation of specific occurrences thereof—and a demonstration that different models of activism are present both in the U.S. and around the globe. In this way, the paper responds to calls from academia, practitioners, and the U.S. legislature for potential regulatory changes aimed at shareholder activism.*

*By surveying eleven different countries and the models of activism prevalent therein, and by widening the framework to account for the myriad forms of shareholder activism, this paper fills an important gap in current corporate governance literature. In particular, the paper's main argument is that calls for regulatory changes are currently framed both too specifically and too generally. By targeting specific actors like hedge funds without accounting for how such reform may affect other players, these regulatory proposals operate too narrowly. Still, others increasingly call for the adoption of specific arrangements from foreign jurisdictions without considering a full model of activism. This paper tackles these issues by providing a comparative examination of different models and proposing a procedural framework for any discussion of shareholder activism.*

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## I. INTRODUCTION

Shareholder activism has dominated contemporary corporate governance literature over the last decade. Recent events underscore the importance

of activism within contemporary corporate governance literature. For example, consider the legal injunction granted to a hedge fund actively attacking governance arrangements of Apple Inc.<sup>2</sup> and the sharp stock movements following the public fight between iconic activist Carl Icahn and hedge fund manager Bill Ackman over Herbalife shares.<sup>3</sup>

The question of the role that shareholders should take in the widely held corporation is a complex one. Shareholders play a crucial role in different corporate systems around the world. Recently, the debate has mostly shifted from the question of whether the corporation needs to maximize shareholders' interests to the question of how governance, regulation, and participation by shareholders can achieve that goal most efficiently.<sup>4</sup> Moreover, while different legal regimes tend to have different corporate structures and thus different agency costs, it appears that the involvement and accessibility of shareholders plays a significant role across the globe.

While scholarly literature is consistently conflicted on the issue of how much power shareholders should have over corporate structure and operation,<sup>5</sup> most scholars agree that some form of involvement is needed to improve corporate governance and to maximize shareholder value.<sup>6</sup> Therefore, the relevant question shifts from whether or not shareholder activism is needed to what forms of activism are efficient<sup>7</sup> and what forms are destruc-

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<sup>2</sup> While the suit was aimed at Apple's bundling of several matters under one management proposal, the underlying motive involved Apple's overall dividend policy and the large amount of cash Apple was hoarding. See Jennifer Ablan & Poomima Gupta, *Einhorn Sues Apple, Marks Biggest Investor Challenge in Years*, REUTERS (Feb. 7, 2013), <http://www.reuters.com/article/2013/02/07/us-apple-greenlight-idUSBRE9160MI20130207>; see also, William Alden, *Einhorn's Apple Suit Fits a History of Public Calls*, N.Y. TIMES DEALBOOK (Feb. 7, 2013), <http://dealbook.nytimes.com/2013/02/07/taking-on-apple-einhorn-has-a-history-of-public-calls>.

<sup>3</sup> See Jeff Macke, *Icahn vs. Ackman: Stay Away from Stocks Manipulated by the 1%, Says Munson*, YAHOO FIN. (Feb. 15, 2013, 10:37 AM), <http://finance.yahoo.com/blogs/breakout/icahn-vs-ackman-stay-away-stocks-manipulated-1-153741894.html>.

<sup>4</sup> For a description of the prevailing approach, as well as a different outlook on the corporate purpose, see Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 247-328 (1999).

<sup>5</sup> Supporters of increasing shareholder powers are led by Professor Lucian Bebchuk. See, e.g., Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, HARV. L. REV. 118, 833-914 (2005). For the opposing view most vocally advocated, see Eric S. Robinson, *Classified Boards Once Again Prove Their Value to Shareholders in Recent Takeover Battle*, Wachtell, Lipton, Rosen & Katz (Aug. 20, 2007), <http://blogs.law.harvard.edu/corpgov/files/2007/11/20071020-staggered-boards1.pdf>. For further opposition to Professor Bebchuk's view, see, e.g., Theodore N. Mirvis et al., *Bebchuk's 'Case for Increasing Shareholder Power': An Opposition*, 121 HARV. L. REV. 43, 43-53 (2007).

<sup>6</sup> Even some of the strongest opponents to Professor Bebchuk's suggested reforms acknowledge the importance of some form of shareholders' involvement. See Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 69 (2003).

<sup>7</sup> Evidence is divided on the actual benefits of shareholder activism. For discussion on the kind of activism used by traditional institutions, see Roberta Romano, *Less Is More: Making Shareholder Activism a Valued Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 187-219 (2001).

tive.<sup>8</sup> The increasing involvement of shareholders, alongside high levels of hedge fund activism, warrants determination as to what extent shareholders should play an active role in corporate affairs. This change in the landscape of shareholder activism in the U.S. has led to calls from academia, practitioners, and the legislature for potential regulatory reform aimed at addressing the increase in activism.

This paper seeks to explore whether reform is warranted and what form it should take. By widening the framework to account for the myriad forms of shareholder activism, this paper fills an important gap in current corporate governance literature. This paper's main argument is that while the emergence of high-profile activists such as hedge funds has led to justified debate, the calls for regulatory changes are currently constructed both too specifically and too generally: too specifically by targeting particular actors, such as hedge funds, without carefully accounting for other models of activism that could or should be impacted by such reform, and too generally by increasingly importing specific arrangements from other jurisdictions without considering the context of these arrangements within these differing models.

This paper tackles these issues by putting forward a novel theory situating shareholder activism within a more complete framework that treats activism as a collection of models that differ in motives, tools, and structure. By providing a more complete perspective on activism—an analytical understanding of activism as a model, rather than as an investigation of specific occurrences thereof—and a demonstration that different models of activism are present both in the U.S. and around the globe by surveying eleven coun-

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<sup>8</sup> One of the main concerns is about the use of activism for short-term self-interest over the long-term efficiency of the firm. This is balanced against the risk of potentially leading to over-activism that will distort daily life at the firm and harm the board and management's ability to steer the corporation effectively. See, e.g., Lynn Stout, *THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC*, 63-73 (2012); Stephen M. Bainbridge, *Response, Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1744-51 (2006); William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 653-54, 657-59 (2010); Justin Fox & Jay W. Lorsch, *What Good Are Shareholders?*, HARVARD BUS. REV., July-Aug. 2012, at 49, 51 (discussing problems created by increase in shareholder power and rise of short-term investors). Similar concerns were raised regarding hedge funds' use of derivatives to manipulate other shareholders. See Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 821, 824 (2006); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1072-1087 (2007). Recent research has cast some doubt on the empirical validity of these concerns. See, e.g., Lucian A. Bebchuk, *The Myth that Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637 (2013) (discussing the theoretical flaws in the arguments to limit shareholder empowerment); Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, (Columbia Business School Research Paper No. 13-66, 2013), available at <http://ssrn.com/abstract=2291577> (2013) (providing empirical evidence regarding the positive effects hedge funds have on firm performance in the long term); Mark J. Roe, *Corporate Short-Termism - In the Boardroom and in the Courtroom*, Business Lawyer 68 (2013); and Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders* (ECGI - Law Working Paper No. 200, 2013), available at <http://ssrn.com/abstract=2227080>.

tries, this paper provides a response to calls from academia, practitioners, and the legislature for potential regulatory changes aimed at shareholder activism.

The paper contributes to the existing literature on both the theoretical and comparative fronts. First, the paper presents a novel taxonomy of shareholder activism. While the current literature is more focused on particular manifestations of shareholder activism,<sup>9</sup> this paper takes a step back and introduces a new analytical prism for the debate. This is particularly important because focusing only on specific forms of activism might lead to erroneous conclusions regarding activism more broadly. The taxonomy developed in this paper creates a common framework for understanding and analyzing the shareholder activism phenomena. It also provides valuable insight as to the different levers available to a policy maker for containing or incentivizing activism.

Second, this paper provides valuable information on the prevalence of shareholder activism around the world while illustrating how the theoretical taxonomy set forth is present in real-world practice. This survey also fills a void in shareholder activism scholarship, a much discussed subject in the U.S. and internationally that has been relatively unexplored from a comparative perspective.<sup>10</sup>

This paper proceeds first with Part II, which reviews the current academic discussion and developments with regard to shareholder activism in the U.S. In Part III, the discussion shifts from the narrow U.S. perspective and the specific questions of activism's purpose and efficiency to a more holistic approach focusing on creating a new taxonomy for the activism debate. In particular, this taxonomy seeks to classify different models of activism across the world according to several parameters. Part IV applies the analytical framework introduced in Part III to show its real life materialization in a survey of eleven countries around the world. Part V presents theoretical and practical implications of the above-mentioned analysis, and Part VI concludes.

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<sup>9</sup> Hedge fund activism in the U.S. is a particularly common topic and recent discourse has mainly focused on these activist players. *See, e.g.*, Kahan & Rock, *supra* note 8, at 1026; Bebchuk *supra* note 8, at 1658–1170; Bebchuk, et al., *supra* note 8, at 1–5.

<sup>10</sup> *See* Sofie Cools, *The Real Difference in Corporate Law Between the United States and Continental Europe: Distribution of Powers*, 30 DEL. J. CORP. L. 697, 698, 736–50 (2005). This void may be the result of the perception that shareholder activism is country-specific and that a comparative approach cannot provide beneficial information. This paper refutes such a perception.

## II. SHAREHOLDER ACTIVISM IN THE U.S.

## A. General Overview

In the U.S., with its widely held public corporations, the steering of the corporate ship is in the hands of management and the board of directors.<sup>11</sup> Adolf Berle and Gardiner Means introduced their agency theory of the publicly traded U.S. corporation's dispersed ownership scheme over eighty years ago,<sup>12</sup> identifying an acute agency cost between management and shareholders in publicly held American corporations.<sup>13</sup> Under the traditional view, shareholders' dispersed ownership led to small economic interests in specific firms. Because a potential shareholder-monitor's share of improved corporate efficiency would be too small to cover the sunk costs of monitoring, the shareholder would be unlikely to supervise management in the first place. These collective action concerns effectively led to a manager-dominated corporate structure. Having no significant monitoring or removal concerns, managers could divert corporate resources into their own hands, receive high compensation not correlated with their performance,<sup>14</sup> and engage in inefficient activities such as empire-building.<sup>15</sup>

Due to the way that current law intersects with the structure of shareholders' equity interests, shareholders face several obstacles<sup>16</sup> that often result in their passive approach. However, some shareholders try to challenge the discretion of the board of directors and management by actively using their rights to create some form of a checks-and-balances structure. The need

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<sup>11</sup> Section 141(a) of Delaware's corporate code states, "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors." DEL. CODE ANN. tit. 8, § 141(a) (2006).

<sup>12</sup> Adolf A. Berle & Gardiner C. Means, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 6 (1932).

<sup>13</sup> "Agency costs include the costs of structuring, monitoring, and bonding a set of contracts among agents with conflicting interests." Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 304 (1983).

<sup>14</sup> See Lucian Bebchuk & Jesse Fried, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 159–64 (2004). The authors assert that executive compensation, even when it is based largely on equity incentives (i.e., options) that should align managers' interests with those of the shareholders, is not adequately correlated to their true performance, enabling executives to benefit from industry success rather than their own efforts.

<sup>15</sup> Empire-building occurs when managers seek to expand the corporate group under their control through M&A or other methods. While M&A activity in general can be efficient, the difficulty arises when managers are more concerned with expanding their business units and the dollar value of assets under their control than they are with maximizing shareholder value. See Sharon Hannes, *Private Benefits of Control, Antitakeover Defenses, and the Perils of Federal Intervention*, 2 BERKELEY BUS. L. J. 263, 283 (2005); David J. Denis et al., *Agency Problems, Equity Ownership, and Corporate Diversification*, 52 J. FIN. 135, 135–36 (1997). But see Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q. J. ECON. 107, 136–37, 145 (2003).

<sup>16</sup> Common obstacles include proxy rules and reimbursement policies, the lack of binding power of shareholders' resolutions, and costs related to nominating board candidates. See Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 688–89 (2007).

for shareholder involvement and supervision stems from the potential misalignment of management's interests and those of the shareholders, often referred to as the agency problem.<sup>17</sup> The board of directors, though charged with representing shareholder interests, is not always effective at mitigating this disparity of interests.<sup>18</sup>

Thus, a principal concern of many academics, legislatures, and courts over the last thirty years has been how to reduce the agency costs created by the disparity of interests between shareholders and management.<sup>19</sup> Some parties have relied upon external free market mechanisms, such as the markets for corporate control,<sup>20</sup> for new shares,<sup>21</sup> for trading shares,<sup>22</sup> for managers,<sup>23</sup>

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<sup>17</sup> See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); see also Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323–29 (1986).

<sup>18</sup> In recent years, however, the composition of many boards has shifted from an insiders' board to an outside directors-controlled board, due in part to the Enron and WorldCom scandals, the Sarbanes-Oxley Act (SOX), and stock exchange rules that followed. See NYSE MKT LLC RULES § 121A (2004), available at [http://wallstreet.cch.com/MKTtools/PlatformViewer.asp?SelectedNode=chp\\_1\\_1\\_1&manual=/MKT/CompanyGuide/mkt-company-guide](http://wallstreet.cch.com/MKTtools/PlatformViewer.asp?SelectedNode=chp_1_1_1&manual=/MKT/CompanyGuide/mkt-company-guide); NASDAQ, Inc., Manual § 4350(c)(1) (2006), available at <http://nasdaq.complinet.com/nasdaq/display/index.html>; NYSE LISTED COMPANY MANUAL § 303A.01 (2003), available at <http://nysemanual.nyse.com/LCMTTools/PlatformViewer.asp?selectednode=chp%5F1%5F4%5F3&manual=%2Ffcm%2Fsections%2Ffcm%2Dsections%2F>. The question remains as to how effective and well-incentivized the board of directors is. See Bebchuk, *supra* note 16, at 681–82. For a review of the changes to board structure and issues current board structure presents, see generally, Yaron Nili, *The New Insiders – The Limited Case for Capping Board Tenure*, (Working Paper 2013) (on file with the author).

<sup>19</sup> See Ronald L. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231 (2008). Gilson and Whitehead refer to Jensen and Meckling's seminal paper as the starting point of this ongoing academic debate. See generally Jensen & Meckling, *supra* note 17.

<sup>20</sup> See Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965); see generally Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981). While the market for corporate control might have played an important role until the mid-1980s, it has weakened substantially since Delaware courts allowed the combined use of poison pills, staggered boards, and the board's ability to "just say no" in rejecting the offers of hostile bidders. Increasing shareholders' involvement in corporate life has recently become an even more crucial issue due to the hostile takeover market's ineffectiveness under new antitakeover mechanisms. See Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 410–12 (2005); Lucian A. Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 889 (2002). Yet, the new wave of private equity buyouts in 2006 and 2007 might signal a shift towards a reemergence of the market for corporate control.

<sup>21</sup> Capital markets might play a role in limiting managerial agency costs. The argument is as follows: if managers have to go back to the markets and raise equity, they will have improved incentives to run the company well, as they are dependent on good performance for raising new equity. However, the effectiveness of using this market for new capital as a constraint is limited. First, some corporations have steady cash flows from income that excuses them from going back to the capital markets for additional capital. Second, the impact that newly issued shares' value sensitivity will have on managers' behavior is not clear. See Bebchuk, *supra* note 16, at 715.

<sup>22</sup> Under the efficient capital market hypothesis, inefficient governance will be reflected almost immediately in share price. Investors could thus sell their shares in a badly managed corporation and use this power to restrain management. See Kent Greenfield, *The Place of*



and for products,<sup>24</sup> as being sufficient to minimize this agency cost problem. Others have relied on debt financing as an effective constraint on this agency concern by reducing the available cash flow a manager can play with and by subordinating managers to debtors' rights.<sup>25</sup> Some scholars have thought that the increasing involvement of traditional institutional investors<sup>26</sup> in the capital markets could mitigate these agency costs.<sup>27</sup> Finally, some have relied on the improved financial incentives that might be given to upper management in a fashion that would align their interests with those of shareholders.

Despite academics' hopes, the traditional institutional investors failed to mitigate the ill-effects associated with the agency problem.<sup>28</sup> A complex set of circumstances, including regulation<sup>29</sup> and fee structure,<sup>30</sup> led those tradi-

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*Workers in Corporate Law*, 39 B.C. L. REV. 283, 296-97 (1998). For a review of the efficient capital market hypothesis, see generally Ronald J. Gilson & Bernard S. Black, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 135-81 (2d ed. 1995). But see Bebchuk, *supra* note 16, at 715, for Professor Bebchuk's criticism of this argument's validity.

<sup>23</sup> Managers would strive to act more efficiently if the market for managers could provide substitutes and thereby hold executives more accountable. It would also increase manager motivation by creating more opportunities to leverage impressive performance into a superior job. Arthur R. Pinto, *Corporate Governance: Monitoring the Board of Directors in American Corporations*, 46 AM. J. COMP. L. 317, 330 (1998). See generally Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461 (1992).

<sup>24</sup> A corporation's competition against rivals in the product market will force managers to act efficiently because inability to compete in the product market would push the corporation out of its business entirely. See Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1264 (1982).

<sup>25</sup> Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. 323, 324 (1986). Jensen took a step further, asserting that the leveraged buyouts of the 1980s mark the starting point of the decline of the public widely held corporation altogether. See Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV. (Sept. 1989, revised 1997), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=146149](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=146149).

<sup>26</sup> In the paper, I will distinguish between traditional institutional investors (e.g., public and corporate pension funds, mutual funds, insurance companies) and newer institutional investors (hedge funds and private equity firms).

<sup>27</sup> See Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); see also Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991).

<sup>28</sup> See Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991); Mark Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991); see also Kahan & Rock, *supra* note 8.

<sup>29</sup> Other than the regulations that ordinary investors face, such as the requirement to file form 13D or 13G with the SEC when crossing an ownership threshold, financial institutions must comply with another set of specific regulations that has made their activism a scarce phenomenon. See, e.g., Roe, *supra* note 28, at 19-22; Mauro Miccoli, *Mutual Funds Activism (?) in Corporate Governance* (Feb. 2002), available at <http://ssrn.com/abstract=302382>.

<sup>30</sup> The fee structure used by traditional institutions has a direct influence on their activism. The fee structure in those institutions is correlated with their size, not with their performance. For example, those institutions are basing their income on management fees, which do not depend on portfolio performance (institutions use this fee structure for legal reasons and to address free riding concerns) and thus they have less of an incentive to invest internal funds in activism. New institutions use an incentivized fee structure, commonly called 2/20, which gives them twenty percent of the portfolio upside (without sharing the downside) and a two percent management fee, which induces them to invest funds in improving governance. See, e.g., John C. Coffee, *The SEC and The Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837 (1994); Bernard S. Black, *Shareholder Activism and Corporate Governance*

tional institutions to take a generally passive approach to governing corporations in their portfolios. The passivity of those institutions led to a new movement seeking to decrease monitoring costs of small shareholders and to induce them to take an active role in the governance of the corporation and the shifting of the power from the managers to shareholders.<sup>31</sup>

In conjunction with this new movement, activism has begun to flourish over the last ten years. The emergence of hedge funds and private equity firms has created a surge in the activism movement in the U.S.<sup>32</sup> This surge, coupled with vocal academics supporting the shareholder franchise and calling for more shareholder involvement in corporate life,<sup>33</sup> has led to a highly charged debate on the merits of increased shareholder activism in the governance of widely held corporations.<sup>34</sup>

## B. Shareholders Activism: From Theory to Practice

### 1. Identifying the Overarching Elements That Affect Activism

As a practical matter, there are two different factors that determine the likelihood that shareholder activism will play a substantive role in the corporate governance of a widely held corporation. The first is the incentive of shareholders to be active. This incentive is a function of the benefits that these shareholders expect to realize from their activism, balanced against the costs (monetary and other) such actions incur. The second factor is the pre-determined rules of the game<sup>35</sup> or, as this paper terms them, “exogenous factors,”<sup>36</sup> such as the presence of legal and economic obstacles that impact a shareholder’s willingness to become active. Certainly, these two elements

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in the United States, in *THE NEW PALGRAVE DICTIONARY OF ECON. AND THE LAW* 459 (Peter Newman ed., 1998)

<sup>31</sup> The main proponent of this movement is Professor Bebchuk. See Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784 (2006); Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 83 (2005).

<sup>32</sup> See Bebchuk, *supra* note 16, at 726; Kahan & Rock, *supra* note 8, at 1024; Bebchuk et al., *supra* note 8, at 1–5. However, one has to bear in mind that the issue of shareholder activism does not hinge solely on the question of who is willing to take an activist role. The corporate legal structure of the U.S. system plays a crucial role in limiting the involvement of shareholders in the corporation. Delaware common law and federal regulations limit the possibility of shareholder involvement even when there is a willingness among shareholders to participate.

<sup>33</sup> See *supra* note 31 and accompanying text.

<sup>34</sup> See *supra* note 8; see also Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733 (2007).

<sup>35</sup> Bebchuk has used this term extensively in his campaign to allow for more shareholder power. His referral to rules of the game is centered upon the single corporation and focuses on the rules that govern the corporation itself through its charter. My reference to rules of the game does not look at a single corporation but at the legal and political environment as a whole. See Bebchuk, *Letting Shareholders Set the Rules*, *supra* note 31.

<sup>36</sup> By exogenous factors, I refer to their applicability to any single activist player. I do acknowledge that these factors, rules, and regulations are shaped and contested by myriad factors and powers, one of which is the lobbying of corporate governance players from all sides, including shareholder activists.

interact with each other and cannot be treated as independent. For instance, there is a need for more incentivized shareholders in an environment with high exogenous obstacles for activism and vice versa. While these elements can complement each other, they might also restrain each other. For instance, while reducing the exogenous barriers to shareholder involvement will help new institutions become more active, it will also enable small equity holders to have their voices heard, thereby diluting the power and influence (and possibly the profits) of the large active players, and thus possibly reducing large players' initial incentive to be active.<sup>37</sup>

The interaction between various mechanisms of governance and the different players utilizing them is complex. The emergence of one might come at the expense of the other, and at other times one will drive the emergence of the other. Thus, an optimal equilibrium allowing for the right mix of players and shareholder empowerment tools is much more complicated to design than it might seem at first glance.

## 2. *Examining Changes in Shareholders' Incentives: The Failure of Traditional Institutions and the Emergence of the New Wave of Activism*

As noted above, prior to the emergence of the new activist investors, it was hoped that traditional institutional investors would act as shareholders' safeguards. In reality, however, their active involvement was barely noticed. Most traditional institutions were limited in the amount of equity stake they could hold in a single corporation and in the composition of their financial compensation structure.<sup>38</sup> The traditional institutions suffered from conflicts of interest and political influence<sup>39</sup> that prevented or decreased their level of

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<sup>37</sup> The contention would be that the increased involvement of small investors might create noise in the activism map, making it more difficult for the large players to have the desired impact or to convince other shareholders to support their actions (for example, excessive "noise" might induce passive shareholders to become even more passive – isolating themselves from any involvement with voting). From an ex-ante perspective, the presence of more activism by small shareholders might reduce the expected value that a large activist may see, either since the "small scale" activism would reduce the level of improvement in share price the large activist may expect of full-fledged campaign or because the costs associated with such campaign would increase (these costs could be higher due to the higher level of noise the small activists might create).

<sup>38</sup> See *supra* note 30 and accompanying text.

<sup>39</sup> See generally, Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, (1993); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Diane Del Guercio & Jennifer Hawkins, *The Motivation and Impact of Pension Fund Activism*, 52 J. FIN. ECON. 293 (1999); Stuart L. Gillan & Laura T. Starks, *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, 57 J. FIN. ECON. 275 (2000); Jonathan M. Karpoff et al., *Corporate Governance and Shareholder Initiatives: Empirical Evidence*, 42 J. FIN. ECON. 365 (1996).

activism,<sup>40</sup> and these factors reduced their incentives to invest in improving governance.<sup>41</sup>

Hedge funds<sup>42</sup> and private equity funds, on the other hand, are free from these regulatory limitations:<sup>43</sup> they are not limited in the amount of equity they can acquire in one corporation; they have incentive-based fee structures;<sup>44</sup> and they are not bound by political or business constraints.<sup>45</sup> The presence of these players has enabled activism to transform from a limited occurrence to a reality that dominates both corporate governance scholarly debates and the business arena. The increasing involvement of these new institutions and the emergence of proxy advisory firms have also stimulated the activism conducted by traditional institutions, leading to an increase in the number of shareholders willing to take an active role in the governance of the corporation.

### 3. *Examining Changes to the Exogenous Factors: The Shareholder Franchise Approach*

Alongside the emergence of new players engaging in activism, a second element receiving increasing attention is the call to break down some of the barriers limiting shareholder intervention in corporate governance. Among those barriers are the legal and proxy rules regarding board elections and shareholders' resolutions,<sup>46</sup> the staggered board, and the poison pill.<sup>47</sup> The

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<sup>40</sup> See Kahan & Rock, *supra* note 8, at 1048.

<sup>41</sup> Direct regulation and tax regulation prevented institutions from holding large stakes in a single corporation. See Roe, *supra* note 28, at 17–30.

<sup>42</sup> The introduction of new players in the U.S. arena is very much the outcome of exogenous factors (see *infra* Part III for the third spectrum in the model this paper develops). Developments in the world economy, in particular the introduction of efficient derivative markets, have spurred the activity of hedge funds and made them central players in U.S. asset investments. See René Stulz, *Hedge Funds: Past, Present and Future* (Fisher Coll. of Bus., Working Paper No. 2007-3, 2007), available at <http://ssrn.com/abstract=939629> at 7.

<sup>43</sup> For a discussion of hedge funds, see William W. Bratton, *Hedge Funds and Governance Targets* 1375–1433 (ECGI Law Working Paper No. 80, 2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=928689](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=928689) (explaining how hedge funds are not subject to the Investment Company Act of 1940). For a discussion of private equity funds, see generally Brian Cheffins & John Armour, *Eclipse of Private Equity* (ECGI Working Paper No. 82, 2007), available at <http://ssrn.com/abstract=982114>.

<sup>44</sup> See *supra* note 30 and accompanying text.

<sup>45</sup> See *supra* note 30 and accompanying text.

<sup>46</sup> Under the current legal regime, a shareholder launching a proxy fight has to incur all costs, shareholders cannot nominate board nominees on the company ballot, and their resolutions are in most cases precatory. Recently, the SEC denied an initiative to allow shareholders direct access to the nomination ballot through Rule 14a-8. See Lucian A. Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43 (2003); Melvin A. Eisenberg, *Access to the Corporate Proxy Machine*, 83 HARV. L. REV. 1489 (1970); Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205 (2005); William K. Sjostrom, Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459 (2007); see also Bebchuk, *supra* note 16, at 688–94.

<sup>47</sup> The staggered board is a charter provision that allows for the replacement of only a portion of the board, usually one third, in each annual shareholders meeting. The poison pill is a mechanism that can only be revoked by the board of directors. It prevents a hostile buyer

proponents of breaking down these barriers, led by Professor Lucian Bebchuk,<sup>48</sup> assert that giving shareholders an effective say in corporate governance will limit managerial slack and lead to more efficient corporations.

Indeed, such movements have seen some success in recent years. The SEC has implemented a reform to its proxy rules easing the ability of shareholders to voice their opinion and elect board members.<sup>49</sup> Congress has passed an extensive bill that has continued the trend of the shareholder franchise (but to some extent, also regulates sophisticated financial players and thus potentially limits their incentives and tools for activism).<sup>50</sup>

While the call for increased shareholder activism was never a subject of consensus,<sup>51</sup> the excessive risk-taking and short-term actions that contributed to the collapse of major financial institutions have bolstered the critique against shareholder empowerment. Some scholars have even argued that in-

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from taking control by giving cheap purchase options to all shareholders excluding the bidder, thus diluting the hostile party's share in the corporation. The combination of the staggered board and the poison pill leads a hostile bidder, even if he has the support of shareholders, to wait two to three years before he gains control on the board, a reality that often prevents the hostile takeover altogether. For the effectiveness of these mechanisms see Lucian A. Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002).

<sup>48</sup> Professor Bebchuk has published several papers advocating this change. See *supra* notes 8 and 16; see also Brief for Harvard Law School Professors as Amici Curiae Supporting Appellants, *AFSCME v. AIG*, 462 F.3d 121 (2d Cir. Aug. 23, 2005) (No. 05-2825-cv), available at <http://www.law.harvard.edu/faculty/bebchuk/pdfs/Amicus%20Brief.pdf>.

<sup>49</sup> For a full review, see *infra* note 238 and accompanying text.

<sup>50</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). The Dodd-Frank Act is not focused on activist players but has some implications for important activists such as hedge funds and private equity firms. One outcome of the Act is a requirement that some players register and be subject to disclosure duties if certain conditions apply. In addition, the Act requires that the SEC set some rules in regard to executive compensation and shareholder ratification of such compensation ("say on pay"). A full analysis of the Act is not within the realm of this paper, but for a review of its main provisions, see S. COMM. ON BANKING, HOUSING, & URBAN AFFAIRS, BRIEF SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (2010), available at [http://banking.senate.gov/public/\\_files/070110\\_Dodd\\_Frank\\_Wall\\_Street\\_Reform\\_comprehensive\\_summary\\_Final.pdf](http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf); David A. Skeel Jr., *The New Financial Deal: Understanding the Dodd-Frank Act and its (Unintended) Consequences* (U. of Penn. Inst. for Law & Econ., Research Paper No. 10-21, Oct. 2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1690979](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1690979). For a critical review of the Act, see Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779 (2011). It is too early to conjecture as to the impact of the bill in the specific context of activism.

<sup>51</sup> See generally Bratton & Wachter, *supra* note 8; see also William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and the Modern Corporation*, 34 J. OF CORP. L. 99 (2008); Stephen M. Bainbridge, *Responses. Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); *Battling for Corporate America – Shareholder Democracy*, ECONOMIST, Mar. 11, 2006; Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857 (1993); Konari Uchida & Peng Xu, *US Barbarians at the Japan Gate: Cross Border Hedge Fund Activism* (Bank of Japan, Working Paper Series No. 08-E-3, Feb. 2008), available at [http://www.boj.or.jp/en/research/wps\\_rev/wps\\_2008/data/wp08e03.pdf](http://www.boj.or.jp/en/research/wps_rev/wps_2008/data/wp08e03.pdf).

creasing shareholder control is bound to increase the likelihood of another major financial crisis.<sup>52</sup>

### C. Shareholder Activism as Mitigating Different Agency Costs

The agency cost between managers and shareholders is particularly serious in the U.S., where most public companies do not have shareholders with sufficient economic interest to supervise and monitor management.<sup>53</sup> A second agency cost that is less common in the U.S. but much more common elsewhere is the agency cost between majority and minority shareholders, where the majority shareholder extracts private benefits of control.<sup>54</sup> In that respect, minority shareholder activism can also play a crucial part in mitigating this second agency cost. This requires constructing a means of empowering minority shareholders that would not merely have the effect of equally increasing the majority shareholders' power over corporate affairs. A more nuanced understanding of shareholder activism would thus play a crucial role in mitigating the agency costs that prevail not only in the U.S. but also in other countries where the agency concerns are different.

## III. THE PROPOSED ANALYTICAL FRAMEWORK

This following Part describes a new method of classifying the shareholder activism debate. Instead of focusing on one particular form of activism, this paper proposes that we deconstruct activism, examining the different components that interact and lead to the appearance of different forms of activism.

### A. A Broad Approach to Shareholder Activism

Shareholder involvement in corporate affairs can be viewed as a continuum of possibilities. At one extreme stands the average investor who is not involved in any aspect of the corporation and whose activism is summed up by holding or selling his stock following the "Wall Street walk."<sup>55</sup> At the

<sup>52</sup> See Bratton & Wachter, *supra* note 8, at 716–725.

<sup>53</sup> See Jensen & Meckling, *supra* note 17.

<sup>54</sup> The main concern of this agency cost is that the majority shareholder will extract corporate resources for its own benefit (also known as "private benefits of control") at the expense of minority shareholders. Such benefits include self-dealing, awarding corporate salaries to controlling shareholders' relatives, and self-use of corporate resources and information. See generally, Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000); Lucian A. Bebchuk, *A Rent-Protection Theory of Corporate Ownership and Control* (Harvard Law and Economics Discussion Paper No. 260, 1999), available at <http://ssrn.com/abstract=168990>; Lucian A. Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Creation and Agency Costs of Separating Control from Cash-Flow Rights*, CONCENTRATED CORPORATE OWNERSHIP 295, 295–315 (Randall K. Morck ed., 2000).

<sup>55</sup> It is claimed that investors can vote with their feet by selling their shares if they are not happy with the firm's performance. This practice is known as the Wall Street walk. For infor-

other extreme are the aggressive shareholders who not only try to influence “rules of the game” decision making,<sup>56</sup> but who also wish to take an active role in the day-to-day business of the firm. Sometimes the literature treats shareholder activism as a type of activity closer to the latter extreme, classifying some other monitoring roles that are closer to the former category as non-activism.<sup>57</sup>

This paper does not take such a narrow perspective. Rather, it examines the full spectrum of activities in which shareholders participate. For the purpose of this paper, shareholder activism is considered to be any governance mechanism utilized by shareholders.

Second, and relatedly, one must establish what the term “shareholder” entails. Do only traditional forms of shareholdings fulfill the requirement that the activism be shareholder activism? Are bondholders excluded from the discussion?<sup>58</sup> What about convertible debt and preferred stock? Should outsiders lobbying for governance changes be part of the discussion? Should owners of voting rights who hold no economic interest in the company be considered shareholders? This paper advocates for a broad approach to examining activism, looking more at motives and tools and less at these formalities.

### B. The Importance of Comparative Research

There is an abundance of academic literature on the benefits<sup>59</sup> and disadvantages of shareholder activism<sup>60</sup> and on the specific ways in which activism manifests itself. As a preliminary point, it is essential to understand that activism employed by shareholders is not a phenomenon unique to the

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mation about the Walk’s influence over managers, see Anat R. Admati & Paul P. Pfleiderer, *The “Wall Street Walk” as a Form of Shareholder Activism*, 22 REV. FINAN. STUD. 2445 (2009); Robert Parrino et al., *Voting with their Feet: Institutional Ownership Changes Around CEO Turnovers*, 68 J. OF FIN. ECON. 3 (2003).

<sup>56</sup> “Rules of the game” are rules that govern procedures and structure. They do not determine the result in a particular subject but determine the structural decision making process. See Bebchuk, *supra* note 16, at 133; see also *supra* note 35 and accompanying text.

<sup>57</sup> See, e.g., Stuart Gillan & Laura T. Starks, *A Survey of Shareholder Activism: Motivation and Empirical Evidence*, 2 CONTEMP. FIN. DIGEST 10 (1998); PETRI MÄNTYSAARI, *COMPARATIVE CORPORATE GOVERNANCE: SHAREHOLDERS AS A RULE-MAKER* (2005); but see Anup Agrawal & Gershon N. Mandelker, *Large Shareholders and the Monitoring of Managers: The Case of Antitakeover Charter Amendments*, 25 J. FIN. & QUANTITATIVE ANALYSIS 143 (1990).

<sup>58</sup> See John Armour & Brian Cheffins, *The Rise and Fall (?) of Shareholder Activism by Hedge Funds*, 14 J. ALT. INVEST. 17 (2012).

<sup>59</sup> Several papers have addressed the issue of activism, and hedge fund activism in particular, in the last few years. See Bratton, *supra* note 43, reviewing both the benefits and the disadvantages of hedge fund activism; Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729 (2008); Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism*, 32 J. CORP. L. 681 (2007); see also *supra* note 9 and accompanying text; Bebchuk, *supra* note 8.

<sup>60</sup> See *supra* note 8.

U.S.; shareholder activism is a global corporate governance affair.<sup>61</sup> That said, different legal regimes, corporate structures, and political atmospheres have led to the development of not only different players, but different models of intervention. The issue becomes even more intriguing when one adds the globalization of capital markets to the story. U.S. hedge funds have started to take a substantive role not only in American corporations, but also in Asian and European corporations, “exporting” their activist methods abroad. Similarly, some models and tools of activism have been, and will be, imported from other countries and introduced into the U.S corporate model.

Thus, a discussion of proposed changes to U.S. corporate governance rules must not only look at what forms of activism are currently prevalent and what means are used to regulate them. It must also address how changes to the current structure, as influenced by other models of activism, will change the entire activism landscape by destabilizing the current balance of power between managers and shareholders and between the shareholders themselves.

### C. *Different Models Of Activism – A New Taxonomy for Shareholder Activism*

In the U.S academic literature, “shareholder activism” is commonly treated as a coherent, homogeneous subject and attention is often directed solely at the major U.S. players, particularly hedge funds. In reality, however, there are different models of activism across the globe and within the U.S. These different models of activism fall along three spectra.

The first spectrum relates to shareholder motive, the reason behind the activist’s actions: is it a social agenda or a monetary interest? If it is the latter, what type of economic interest does the activist have in the corporation? Is it activism that intends to profit from improvements to the governance of a corporation, or is it activism that plans to profit from damaging the

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<sup>61</sup> See, e.g., Olufemi O. Amao & Kenneth M. Amaeshi, *Galvanising Shareholder Activism: A Prerequisite for Effective Corporate Governance and Accountability in Nigeria* (Center for Stud. Of Globalization and Regionalization, Working Paper No. 228/07, 2007), available at <http://ssrn.com/abstract=982577>; Kirsten Anderson et al., *Union Shareholder Activism in the Context of Declining Labour Law Protection: Four Australian Case Studies*, 15 CORP. GOVERNANCE: AN INT’L REV 45 (2007), available at <http://ssrn.com/abstract=954815>; Marco Becht et al., *Returns to Shareholder Activism Evidence from a Clinical Study of the Hermes UK Focus Fund* (Eur. Corp. Governance Inst., Finance Working Paper No. 138/2006, 2008), available at <http://ssrn.com/abstract=934712>; Chao Xi, *Institutional Shareholder Activism in China: Law and Practice*, 17 INT’L CO. & COM. L. REV. 251 (2006), available at <http://ssrn.com/abstract=938455>; Takaya Seki, *Legal Reform and Shareholder Activism by Institutional Investors in Japan*, 13 CORP. GOVERNANCE: AN INT’L REV. 377 (2005), available at <http://ssrn.com/abstract=725886>; Timothy A. Kruse, *Minority Expropriation and Shareholder Activism Following Olivetti’s Hostile Takeover of Telecom Italia*, 15 CORP. GOVERNANCE: AN INT’L REV 133 (2007), available at <http://ssrn.com/abstract=972512>; Jayati Sarkar & Subrata Sarkar, *Large Shareholder Activism in Corporate Governance in Emerging Economies: Evidence from India* (Indira Gandhi Inst. of Dev. Res., Working Paper No. 153, 2000), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=174570](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=174570).



corporation? For instance, an activist trying to convince the corporation to increase its environmental standards is different from a hedge fund trying to induce management to increase dividends. Both are activist shareholders but their agendas and their impact differ. A related and often overlooked matter is the presence of conflicting interests. Often shareholders, particularly institutional investors, have interests in the corporation that go beyond their pure shareholdings position.<sup>62</sup> In such cases, the extent of shareholder activism can be influenced and shaped by more than one's ownership of shares.<sup>63</sup>

The second spectrum is the activist type and profile. First, there are differences in the characteristics of the activist: the activist may be a combination of any of the following: (1) a private or a public player; (2) a for-profit or a non-profit organization; (3) a single investor or a group; (4) a sophisticated financial player with possible hidden agendas, a traditional institution or an individual with minimal means; (5) accountable for its actions, regulated by other laws,<sup>64</sup> or operating in a regulatory void. There are also differences in the frequency of activism: is it a repeating actor or a one-time player? Is its activity as an activist part of its core operation or merely a byproduct of its positions? In other words, is this an "offensive activist" or "defensive activist"?<sup>65</sup> Does the activism manifest itself over a long duration or in short bursts? All of these questions are essential in assessing a shareholder activist's profile.

The third spectrum consists of external considerations: the formation and accumulation of exogenous factors that impact activism. These include the legal and social tools activists employ in an effort to exert influence on the governance of a corporation, the regulation of the financial and social "players" themselves (that is, how hard or easy it is for these players, local or foreign, to exist, and more importantly, whether there is any regulation pertaining directly to their ability to act as activists), the country's legal system, which has a direct impact on ownership structure (and in turn, on the

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<sup>62</sup> For example, the party may act as the underwriter, managing the corporation's pension funds or other investments, or hold corporate debt.

<sup>63</sup> An empirical study conducted in Israel shows that the conflict of interests by institutional shareholders plays an extremely important part in their activism, even more so than the legal tools at their disposal. See Assaf Hamdani & Yishay Yafeh, *Institutional Investors as Minority Shareholders: Do They Matter When Ownership Is Concentrated* (Centre for Econ. Pol'y Res., Discussion Paper No. 7934, 2010), available at <http://www.cepr.org/pubs/dps/DP7934.asp#>.

<sup>64</sup> For example, an insurance company is subject to standards, regulations, and laws that specifically address the insurance industry.

<sup>65</sup> See Armour & Cheffins, *supra* note 58. Armour and Cheffins present this distinction in their paper, which deals with hedge fund activism. Their main contention is that there is a difference between players who are long-term shareholders acting to protect their investment (defensive) and players who take position in a corporation with the intention of employing activism (offensive). The authors justly distinguish between this motive-basis (offensive or defensive) and the methods in which activism takes place. For instance, offensive activism does not necessarily mean "offensive" or confrontational methods of activism.

type of agency cost the activism is trying to counter),<sup>66</sup> and the developments and effectiveness of market forces<sup>67</sup> in restraining agency costs (and thus reducing the need for activism).<sup>68</sup>

An economy's particular attributes could also play a significant role. The type of industries in the economy could impact activism levels, as some industries are more prone to activism than others.<sup>69</sup> Local and global macroeconomic factors also have direct implications for activism. Market volatility might induce specific activists to increase their involvement.<sup>70</sup> Similarly, credit freezes (or boosts), which leave corporations with high (low) cash flows<sup>71</sup> might induce (dissuade) activists to get involved in divi-

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<sup>66</sup> For the leading scholarship in this area, see Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998); Rafael La Porta et al., *Corporate Ownership around the World*, 54 J. FIN. 471 (1999). However, recent empirical work casts doubt as to the validity of the empirical findings in the La Porta et al. scholarship. See Holger Spamann, *The "Antidirector Rights Index" Revisited*, 23 REV. FIN. STUD. 467 (2010) (showing flaws in the antidirector rights index that was introduced by La Porta et al. in their Law and Finance paper. It has since been used as a measure of shareholder protection in over a hundred articles.).

<sup>67</sup> It is believed that several market forces can help in restraining agency costs. Among these are the market for corporate control, the market for new capital, the product market, the market for shares, and the labor market. In the U.S., legal scholarship has questioned the effectiveness of these markets. See Bebchuk, *supra* note 16, at § III.B.

<sup>68</sup> See Eric Berglöf & Ernst-Ludwig von Thadden, *The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries* (Ann. World Bank Conf. on Dev. Econ., Wash. D.C., Conference Paper, 1999), reviewing five different models of governance (or corporate structure) and the implications from a policy perspective as to how to best facilitate the governance of the countries' corporations.

<sup>69</sup> For example, industries that have higher cash flows and retained earnings are likely to be targeted by activists looking for increased dividends. Similarly, private equity firms tend to target mature firms with stable income and assets (to allow for the leverage they use). On the other hand, high-tech companies are less likely to be targeted by activists. See Raghuram G. Rajan & Luigi Zingales, *Financial Dependence and Growth*, 88 AM. ECON. REV. 559 (1998); Matias Braun & Borja Larrain, *Finance and the Business Cycle: International, Inter-Industry Evidence*, 60 J. FIN. 1097 (2005) (dealing with industry variance and its implications on growth and finance). For a review of private equity targets, see Brian Cheffins & John Armour, *The Eclipse of Private Equity* (ECGI Working Paper Ser. in Law, Paper No. 82, 2007), available at <http://ssrn.com/abstract=982114>; Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity* (Working Paper June 2008), available at <http://ssrn.com/abstract=1194962>. For a review of hedge fund activity and targets, see Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance* (ECGI Fin., Working Paper No. 139, 2006), available at <http://ssrn.com/abstract=948907>.

<sup>70</sup> This could be caused by under or overvaluation of firms, both of which are more likely to occur in a volatile market. In the specific case of hostile takeovers in volatile markets, there is a higher likelihood of fundamental disagreement between the target and the bidder on correct share value, thus leading to fewer friendly acquisitions and more hostile ones. Similarly, Andrei Shleifer and Robert Vishny explain variations in the type of M&A activity in the U.S. with market valuations (overpricing or underpricing). See Andrei Shleifer & Robert Vishny, *Stock Market Driven Acquisitions*, 70 J. OF FIN. ECON. 295 (2003).

<sup>71</sup> For instance, due to the last credit crisis, the level of free cash flows hit a high in 2010 when the economy fundamentals improved but credit and investment were still scarce (7.18% cash to assets). See Charles W. Mulford, *Cash Flow Trends and their Fundamental Drivers: Comprehensive Industry Review (Quarter 2, 2013)*, SCHELLER COLLEGE OF BUSINESS, GEORGIA INSTITUTE OF TECHNOLOGY, [http://scheller.gatech.edu/fac\\_research/centers\\_initiatives/finlab/finlab\\_files/gatech\\_finlab\\_industry\\_q22013.pdf](http://scheller.gatech.edu/fac_research/centers_initiatives/finlab/finlab_files/gatech_finlab_industry_q22013.pdf).

dend policy.<sup>72</sup> Spurring economy and low base interest rates might also impact activism, inducing wealthy individuals to turn to alternative investment vehicles and innovative investment strategies to maximize the return on their savings. Finally, developments in financial tools and trading impact activists.<sup>73</sup>

None of the spectra stands on its own. Each model of activism has produced a tentative equilibrium between these interacting parameters. A change in any of the spectra will lead to a new equilibrium, stimulating new forms of activism and eliminating others. As discussed below, a policymaker must understand this factor when considering regulatory reforms. Any reform and cost-benefit analysis must account both for the current issues current regulation fails to address and the likely effects of such change.

The deconstruction of activism into its basic foundations is extremely important. This paper's main contention is that the current debate oversimplifies the activism phenomenon, focusing on specific manifestations of it, rather than first setting up the foundations upon which such discussion can be held. The over-compartmentalization of the topic into specific investigations of particular forms of activism creates a situation in which policy makers can't see the forest for the trees. If one neglects to give due weight to the interactions among the different spectra's components, a crucial aspect of activism is omitted: the dormant presence of other forms of activism and the intrinsic value of the interconnection between these forms.

So far, this paper has contended that shareholder activism is a multifaceted phenomenon and that it is much more complex and versatile than the current debate suggests. This section offered a methodical taxonomy through which activism should be viewed. The next section illustrates this proposed taxonomy with practical examples.

#### IV. DIFFERENT MODELS OF ACTIVISM: A COMPARATIVE DEMONSTRATION

Classification and observation of different models of activism is important not only from a purely analytical perspective. Providing a scheme of classification to an area lacking such taxonomy may provide a better normative examination of the current legal structure.

By sampling eleven countries, this paper illustrates the significance of having different models of activism. This survey is not meant to be exhaustive in the number of countries surveyed, in fully describing each country's legal regime, nor in thoroughly accounting for all of a country's activist players. This paper does not seek to provide empirical analysis or normative conclusions as to the desirability of one model or another. Its sole purpose is

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<sup>72</sup> This might induce motivated activists to distribute dividends among shareholders (either to finance a takeover or to reduce management spending).

<sup>73</sup> For example, the development of the derivative market and securitization in the last two decades has increased the involvement of hedge funds in the activism arena. *See supra* note 9 and accompanying text.

to provide real-world examples for the proposition that different models of activism exist and that understanding the complexity and interactions of these models is a much-needed framework for the current debate.<sup>74</sup>

Finally, although this paper presents a snapshot description of activism by highlighting its current status in the surveyed countries, this snapshot is the multilayered result of an aggregation of historical developments. The survey therefore captures both the present and echoes of the past in some regards. This realization—that activism progresses and evolves over time and that it is not a stagnant phenomenon—is crucial to any policy discussion, as Part V explains.

### A. *The United States*

Hedge funds have been the rising stars among activists in the U.S. in recent years. These funds tend to be the focus of most of the attention when it comes to shareholder activism, despite the fact that most of them are not activists at all.<sup>75</sup> It is true, however, that the fee structure of hedge funds, coupled with their tendency to magnify their equity stake by using sophisticated derivatives,<sup>76</sup> has induced some of them to take an active role. Most often, the funds get involved by threatening their portfolio companies with a proxy fight and sometimes launching one.<sup>77</sup> In their efforts to exert influence, hedge funds have also used legal remedies, such as seeking injunctions against management proposals and requesting public declarations of intentions.<sup>78</sup> The activism of these funds serves one purpose only: the maximization of returns. Thus, this activism might also have a dark side, seen through the funds' extraction of short-term value at the expense of long-term plans.<sup>79</sup>

A different model can be found in the emergence of private equity funds. Although these firms are also motivated by economic interest, the model they use is strikingly different. Instead of monitoring the companies'

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<sup>74</sup> This survey does not claim that the models reviewed in each country are the only prevailing models. It might very well be that other forms of activism exist in such countries. The paper does not endeavor or proclaim to estimate the distribution or effectiveness of different models in a given country.

<sup>75</sup> See René Stulz, *Hedge Funds: Past, Present and Future* (Fisher Coll. of Bus., Working Paper No. 2007-3, 2007), available at <http://ssrn.com/abstract=939629>.

<sup>76</sup> Hedge funds tend to use the derivatives market much more commonly and aggressively than other institutions. Thus, a hedge fund can increase its equity interest in a corporation just by buying derivative assets (as put or call options), thereby amplifying its economic interest without needing to increase its actual shareholdings in the firm. See Kahan & Rock, *supra* note 8, at 1062 (noting that 15 percent of hedge funds use leverage at a ratio in excess of two and that 35 to 55 percent use leverage at lower ratios).

<sup>77</sup> See Cheffins & Armour, *supra* note 43, at 69–70.

<sup>78</sup> See Alden, *supra* note 2 and the accompanying discussion, regarding the legal challenge against Apple's attempt to bundle several topics under one management resolution and the motive of the activist hedge fund to force a public discussion over the company payout policy.

<sup>79</sup> See Kahan & Rock, *supra* note 8, at 1072; see also Hu & Black, *supra* note 8, at 821; Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q. J. OF ECON. 655, 664 (1989).

incumbent managers, private equity funds use activism to its extreme, by taking the firm private, parachuting in their own managers to supervise the daily operation of the corporation, and eliminating incumbent managerial control altogether.<sup>80</sup> Private equity firms are also considered to be more long-term oriented, as opposed to the short-term focus of hedge funds.<sup>81</sup>

Traditional financial institutions employ an additional form of activism. For example, public pension funds tend to be rather active in corporate governance issues, but are often understood to be motivated by political considerations rather than economic interest.<sup>82</sup> In sharp contrast to the method taken by private equity and hedge funds, it is claimed that traditional institutions like mutual funds work behind the scenes to impact the governance of the corporation by informally interacting with management.<sup>83</sup> This model can be described as a collaborative model of activism.

An interesting complication can be found in the mutual funds industry. It is not uncommon for economic incentives to play a diminished role in the way the funds vote as a result of the establishment of voting committees that act independently of the funds' finance departments.<sup>84</sup> This separation disentangles activism from monetary incentives, and thus brings about yet another model. Recent theoretical models contend that the mere ability to sell one's shares could alone constitute a form of activism,<sup>85</sup> thereby supplementing the collaborative activism model.

Finally, social actors promoting their agenda through proposed resolutions on corporate ballots are also common in the U.S.<sup>86</sup> In particular, one

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<sup>80</sup> Indeed, some private equity buyouts are also a form of management buyouts ("MBOs"), which receive the support of private equity funds, and, in that case, managers are likely to remain in place. However, pay structure incentivizes managers much more efficiently after the MBO. Monitoring and involvement of the private equity firm is much greater as well. For a more comprehensive analysis of the buyout methods, see Guy Fraser-Sampson, *PRIVATE EQUITY AS AN ASSET CLASS* (2007); Josh Lerner, Felda Hardymon & Ann Leamon, *VENTURE CAPITAL AND PRIVATE EQUITY: A CASEBOOK* (3d ed. 2005); Cheffins & Armour, *supra* note 43.

<sup>81</sup> See Bratton, *supra* note 43, at 1383.

<sup>82</sup> See Romano, *supra* note 39.

<sup>83</sup> See Kahan & Rock, *supra* note 8, at 1044 (referring to "behind-the-scenes" discussions by those institutions).

<sup>84</sup> Vanguard's guidelines of governance provide an apt example. See VANGUARD GUIDELINES OF GOVERNANCE, <http://www.boardoptions.com/vanguardproxy.htm> (last visited Dec. 3, 2013) ("The Vanguard funds' Board of Trustees has established a Proxy Oversight Group, a committee of senior Vanguard officers, to oversee voting policies and decisions for the funds . . . In evaluating issues, the Proxy Oversight Group may consider information from many sources, including the portfolio manager for the fund, management of a company presenting a proposal, shareholder groups, and independent proxy research services. In all cases, however, the ultimate decision rests with the fiduciaries who serve on the Proxy Oversight Group and are accountable to the funds' Board of Trustees.").

<sup>85</sup> See Admati & Pfleiderer, *supra* note 55, at 2658. The authors contend that trading based on internal information by a blockholder could lead managers to align their interests with those of shareholders (assuming they are sensitive to share price).

<sup>86</sup> See Miguel Rojas et al., *Bringing About Changes to Corporate Social Policy Through Shareholder Activism: Filers, Issues, Targets, and Success*, 114 BUS. & SOC'Y REV. 217, 231-32 (2009).

might point to nongovernmental organizations (NGOs), which use media and public relations alongside corporate governance mechanisms<sup>87</sup> when campaigning to sway corporations' socially impactful decisions. This is a hybrid model of activism, taking advantage of internal and external levers of pressure. A famous example of a combined campaign relates to the efforts of Friends of the Earth (FOE) to have Exxon held accountable for environmental issues in the wake of the Valdez oil spill.<sup>88</sup> Although FOE members protested outside the corporate headquarters and its officials lobbied in Washington D.C., FOE also used corporate tools, such as raising questions at the annual meeting, initiating shareholder resolutions, and obtaining proxies to try and pressure Exxon's management.<sup>89</sup> FOE even tried to torpedo a merger of Exxon with Mobil by protesting at the Mobil shareholder meeting.<sup>90</sup>

Notably, the U.S. offers an eclectic collection of shareholder activist models. Contrary to common perceptions, activism in the U.S. is not confined to activism by savvy, for-profit investors (although they are the most visible actors). Rather, myriad models exist and they are spread along the three spectra discussed above. The type is diverse, including both for-profit and non-profit organizations, as well as individual activists and groups. The motives also vary, as some activists are interested in value-maximizing activities and improving governance by supervising managerial activity, while others have economic interests in mind but not necessarily the interests of the corporation or their fellow shareholders.<sup>91</sup> Others still are focused on social rather than economic agendas.

Indeed, even the external factors that theoretically affect all activists in the U.S. cultivate remarkably diverse activism. While some factors apply to all players at any given point (e.g., social norms, general regulation, the court system), some only apply to certain players (e.g., specific regulation, specific incentives), and others are time-dependent (e.g., economic conditions, regulation over time). The varied combination of factors has produced a diverse range of activists, who take action in different forms and at different points in time, often as a response to economic or regulatory changes.

Not only do the motives and methods of U.S. activists differ—so too do the agency concerns the activists seek to mitigate. While most activists aim

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<sup>87</sup> One such corporate mechanism is SEC Rule 14a-8, which allows for inclusion of some shareholder proposals on the company's ballot. For a review of the effectiveness of this approach in the context of social activists, see *id.* at 218. See generally Black, *supra* note 30 (discussing FOE's efforts against Exxon).

<sup>88</sup> See Terrence Guay et al., *Non-Governmental Organizations, Shareholder Activism, and Socially Responsible Investments: Ethical, Strategic, and Governance Implications*, 55 J. BUS. ETHICS 125, 134-35 (2004).

<sup>89</sup> *Id.*

<sup>90</sup> *Id.*

<sup>91</sup> "Empty voting" is an example of this individually-focused economic interest in the context of hedge funds. See Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 640-42 (2008).

to reduce the managerial agency cost, some are more interested in exploiting it in an effort to rip short term gains. Other activists are more concerned with the agency cost between shareholders and other constituents. In contrast, the means of intervention is less diverse, as most activism takes place by voting (or a threat to vote) one's shares.<sup>92</sup>

### B. South Korea

Current shareholder activism in South Korea stands in a sharp contrast to that of the U.S. First, South Korea's Chaebol structure presents an agency cost that mainly lies between controlling shareholders and minority shareholders.<sup>93</sup> Second, the means used for activism are strikingly different. The People's Solidarity for Participatory Democracy (PSPD), a non-profit organization, is the major activist player in Korea's corporate governance.<sup>94</sup> Having no financial interest, and lacking sufficient resources, this NGO uses a distinctive model of activism in which the PSPD detects a slacking corporation, purchases the minimum amount of shares required by law, and files a derivative suit against the corporation's managers. At times, this NGO also files criminal complaints against the managers, leading to criminal investigations.<sup>95</sup> This approach is meant to promote better governance in the Korean system by making an example of badly managed corporations.

The Korean model is different in several respects from the traditional U.S. model. First, an outside player with no solid, short- or long-term economic interest in the firm initiates and implements the intervention, a fact that might result in a disparity of interests between the player and other minority shareholders. Second, the means of intervention is not the exercise or threatened exercise of voting power, but rather the use of legal remedies that lie outside the corporate contractual terms, mainly issued through adjudication.<sup>96</sup>

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<sup>92</sup> Although to a lesser degree, the use of media and public relations by social groups is also common.

<sup>93</sup> The Chaebol structure is characterized by controlling families that use cross shareholdings to control large corporate groups with a small equity stake. See generally Jeong Seo, *Who Will Control Frankenstein? The Korean Chaebol's Corporate Governance*, 14 CARDOZO J. INT'L & COMP. L. 21 (2006); Woonchan Kim et al., *Group Control Motive as a Determinant of Ownership Structure in Business Conglomerates: Evidence from Korea's Chaebols*, 15 PAC.-BASIN FIN. J. 213 (2007); Ok-Rial Song, *The Legacy of Controlling Minority Structure: A Kaleidoscope of Corporate Governance Reform in Korean Chaebol*, 34 LAW & POL'Y INT'L BUS. 183 (2002).

<sup>94</sup> Woon-Youl Choi & Sung Hoon Cho, *Shareholder Activism in Korea: An Analysis of PSPD's Activities*, 11 PAC.-BASIN FIN. J. 349, 351 (2003); Jooyoung Kim & Joongi Kim, *Shareholder Activism in Korea: A Review of How PSPD Has Used Legal Measures to Strengthen Korean Corporate Governance*, 1 J. KOREAN L. 51, 53 (2001).

<sup>95</sup> The Korean code treats the breach of fiduciary duties as a criminal offense. Thus, activists tend to use the criminal adjudicatory route as well as the civil one. See Kim, *supra* note 94, at 69.

<sup>96</sup> Although the organization also utilizes internal governance mechanisms like special shareholders meetings, the majority of activists' successful actions are aided by the judicial

Still, the economic crisis that Korea underwent in 1997 not only motivated the PSPD to act; it also allowed increasing foreign involvement in Korean corporations as well as the creation of a new activist group, the Korea Corporate Governance Fund, financed by foreigners and advised by Korean corporate professors.<sup>97</sup> The activism of this group is much more aligned with the economic interests of minority shareholders, as its objectives are purely economic. This development might reflect an influence of the U.S.' model of economically incentivized and motivated activism on the traditional Korean model, which this paper terms non-profit activism.

### C. Israel

Israel provides an example of yet another model of activism. Like Korea, one of the main activist groups is an NGO—the Movement for Quality Government in Israel (MQG).<sup>98</sup> However, this NGO is not a shareholder at all, not even for the sake of formality. Since a considerable portion of the corporations in Israel are government-controlled,<sup>99</sup> the NGO, among its other objectives,<sup>100</sup> attacks poor governance and corruption in private and publicly-traded government-controlled corporations by either representing shareholders or petitioning directly to the Supreme Court of Israel.<sup>101</sup> In the case of

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system. While the use of the courts is common in the U.S. as well, it is limited in many respects to specific, major corporate events such as mergers (and a likely outcome would be an appraisal remedy, not an action for an injunctive relief). Judicial review is much more limited under the marquee Delaware doctrines relating to internal corporate affairs and the business judgment rule, and suffer from several inefficiencies. See, e.g., Jill E. Fisch, *The Overstated Promise of Corporate Governance*, 77 U. CHI. L. REV. 923, 936–38 (2010). Recently, plaintiffs in the U.S. have started to seek judicial aid outside of Delaware, where the majority of corporate law litigation takes place, in an effort to take advantage of more favorable judicial venues. See, e.g., John Armour et al., *Delaware's Balancing Act*, 87 IND. L.J. 1345 (2012).

<sup>97</sup> This fund was established in 2006 with a strategy of investing in Korean companies whose market values are repressed due to governance problems and is financed by foreign investors and advised by Korean professors. Dong Wook Lee & Kyung Suh Park, *Does Institutional Activism Increase Shareholder Wealth? Evidence from Spillovers on Non-Target Companies*, 15 J. CORP. FIN. 488, 491–92 (2009); see Choe Sang-Hun, *Revenge of the Shareholders: Korean Firms on the Spot*, THE INTERNATIONAL HERALD TRIBUNE (Sept. 11, 2006), [http://www.nytimes.com/2006/09/11/business/worldbusiness/1iht-won.2767323.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2006/09/11/business/worldbusiness/1iht-won.2767323.html?pagewanted=all&_r=0).

<sup>98</sup> The economic department of MQG deals with corporate governance issues in government-controlled corporations. See MOVEMENT FOR QUALITY GOV'T, <http://www.mqg.org.il> (last visited Oct. 6, 2013).

<sup>99</sup> See ASSESSMENT OF GOVERNMENT COS., [http://www.gca.gov.il/NR/RDONLYRES/3CE57F26-96FB-4F54-B55A-CFFB00EAF8C8C/0/MAVO\\_1894.pdf](http://www.gca.gov.il/NR/RDONLYRES/3CE57F26-96FB-4F54-B55A-CFFB00EAF8C8C/0/MAVO_1894.pdf) (last visited Oct. 6, 2013). For statistics and other data, see Official report by the Government Companies Authority, available at <http://www.gca.gov.il/GCA/HomePage/UpperNavigationBar/CompaniesState ment>.

<sup>100</sup> See *Who We Are*, MOVEMENT FOR QUALITY GOVERNMENT IN ISRAEL, <http://www.mqg.org.il/English/Whoware/tabid/175/Default.aspx> (describing the different objectives and departments of the organization).

<sup>101</sup> The Israeli legal system enables petitioning to the Supreme Court of Israel at first instance against any act, or failure to act, of the executive branch. See, e.g., Gad Barzilai, *Courts as Hegemonic Institutions: The Israeli Supreme Court in a Comparative Perspective*, 5 ISRAEL AFF. 15 (1998); Y. Dotan & M. Hofnung, *Interest Groups in the Israeli High Court of*



Israel, this specific form of activism against government-controlled corporations operates without any economic interest, is not conducted by a formal<sup>102</sup> shareholder (although direct shareholders sometimes seek the MQG's involvement as their agent), and works through administrative law, rather than through corporate and securities law.

Recent years have borne witness to various examples of such activism. The MQG, alongside other NGOs, has petitioned the Supreme Court,<sup>103</sup> opposing the nomination of the CEO and role of the chairwoman of the board of Bank Leumi, the second largest bank in Israel and partially owned by the government.<sup>104</sup> The Supreme Court ruled in favor of the MQG, forcing the CEO to remove its nomination. The MQG has also petitioned the court to force the government's nomination committee to vote in a particular manner.<sup>105</sup> In a different matter, the MQG approached the Israeli SEC about the Israel Electric Corporation,<sup>106</sup> which is almost fully owned by the state,<sup>107</sup> consequently raising concerns as to the accuracy of its financial statements.<sup>108</sup> The involvement of an outside actor in core governance issues,<sup>109</sup> such as the nomination of managers and directors, and the scrutiny applied to financial reports through administrative law, are yet other examples of a different form of activism. It is of note that the recent financial crisis and the U.S. bailout program have created a similar, though much more limited, pos-

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*Justice: Measuring Success in Litigation and in Out-of-Court Settlements*, 23 L. & POL. 1 (2001); Israel Gilead, *The Dilemma of Israel's High Court of Justice: The Battle for Human Rights in Times of War*, JURIST (APRIL 16, 2002), <http://jurist.law.pitt.edu/world/israelhcj.php>.

<sup>102</sup> An argument can be made that in a government-owned corporation, every citizen is a shareholder by proxy and the state is acting as an intermediary, just like banks, pension funds, and similar institutions.

<sup>103</sup> See Ran Rimmon, *Second Group Petitions High Court to Halt Maor Nomination*, GLOBES (Feb. 8, 2010), <http://www.globes.co.il/serveen/globes/docview.asp?did=1000537297&fid=1725>.

<sup>104</sup> Israel's government holds 11.46% of the outstanding shares of Bank Leumi, the second largest bank in Israel. Data was taken from the annual report of the bank for 2010. See *Annual Report 2010*, BANK LEUMI <http://english.leumi.co.il/static-files/Media%20Server/BLITA%20English/PDF%20files/Financial%20Statements/10001104e.pdf> (last visited Oct. 6, 2013).

<sup>105</sup> Due to specific regulation of the banks that were nationalized during the banking crisis of the 1980s, in each bank in which the government holds a significant stake, the government appoints a special committee that has exclusive power to nominate the board members to the general shareholder election and thus has practical control over the bank. This committee of the executive branch is subject to the duties set by administrative law and therefore exposed to petitions to the Supreme Court on sweeping grounds. See <http://www.boi.org.il/he/BankingSupervision/Pages/DirectorAppoint.aspx>.

<sup>106</sup> See *Movement for Quality Government Letter*, NEWS1, <http://www.news1.co.il/RedirectToFile.aspx?FileID=1982> (last visited Oct. 6, 2013).

<sup>107</sup> The government holds 99.9% of the Corporation's outstanding shares. See TEL-AVIV STOCK EXCHANGE, <http://tase.co.il/TASEEng/General/Company/companyDetails.htm?companyId=000600&subDataType=1> (last visited Oct. 6, 2013); see ISRAEL ELECTRIC CORP. <http://www.iec.co.il/EN/IR/Pages/AboutTheCompany.aspx> (last visited Oct. 6, 2013).

<sup>108</sup> See *Movement for Quality Government Letter*, *supra* note 106.

<sup>109</sup> Indeed, these examples are restricted to corporations in which the government owns or holds significant stakes, but in Israel these corporations are numerous and some of them are among the largest in Israel. See ASSESSMENT OF STATE-OWNED Cos., *supra* note 99, for the 2008 report by the government agency in charge of such corporations stating that eighty-five major corporations are under government control.

sibility for such a scheme in the U.S., as several public companies were controlled by the government.<sup>110</sup>

Alongside NGO activism, public firms that are not owned by the government are subject to some degree of institutional activism. Since most Israeli corporations are majority shareholder-controlled,<sup>111</sup> their activism is limited but still existent. Israeli law relies heavily on institutional investors as private agents, assisting in the effort to prevent minority expropriation by majority owners. Similarly to other countries, Israeli law requires that self-dealing transactions be approved by a vote of disinterested shareholders,<sup>112</sup> thereby empowering minority shareholders to affect vote outcomes. In addition, Israeli law requires institutional investors to vote on specific matters, thus ensuring that small investors will receive what is presumed to be an expert opinion on management proposals.<sup>113</sup>

Interestingly, empirical research by Hamdani and Yaffe examining institutional shareholders' actions<sup>114</sup> concludes that institutional shareholders are likely to vote against company proposals that are compensation-related, even when institutional investors are unlikely to influence outcomes. They also found that large firms tend to enjoy more favorable treatment from institutional investors, whereas firm performance has virtually no impact on voting, and that conflicts of interest have a strong impact on the likelihood of involvement by institutional investors.<sup>115</sup>

Therefore, Israel's model of activism presents a mixture of motives (both social and financial) and is heavily tilted towards byproduct activists, or organizations that are not focused on activism but occasionally engage in activism as a byproduct of their other goals. The model lacks individuals as activists, favors more traditional institutions and NGOs (due to Israel's con-

<sup>110</sup> See Marcel Kahan & Edward B. Rock, *When the Government Is the Controlling Shareholder*, 89 TEX. L. REV. 1293, 1358–60 (2010).

<sup>111</sup> Recent research estimates that three-quarters of Israeli listed companies (613 as of the end of 2010) are controlled by family or individual interests and that twenty business groups controlled 160 publicly traded companies with a forty percent segment of the market. Kosenko Konstantin, *Evolution of Business Groups in Israel: Their Impact at the Level of the Firm and the Economy*, Bank of Israel (2008), available (in Hebrew) at <http://www.boi.org.il/deptdata/mehkar/papers/dp0802h.pdf>. See also A. Blass, et al., *Corporate Governance in an Emerging Market: The Case of Israel*, 10 J. APPLIED CORP. FIN. 79 (1998); Rafael La Porta, et al., *Corporate Ownership around the World*, 54 J. FIN. 471 (1999); A. Shleifer, & R. W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997).

<sup>112</sup> Audit Committee, Board and General Meeting approval is required for all transactions of a public company with a controlling shareholder or with another person in which the controlling shareholder has a personal interest. In order to obtain General Meeting approval, voting is required and the action must win the support of a majority of the votes of the shareholders who do not have a personal interest in the transaction and who are present. See, e.g., OECD, RELATED PARTY TRANSACTIONS AND MINORITY SHAREHOLDER RIGHTS (2012); OECD, CORPORATE GOVERNANCE IN ISRAEL 2011 (2011).

<sup>113</sup> See Hamdani & Yafeh, *supra* note 63.

<sup>114</sup> See Hamdani & Yafeh, *supra* note 63.

<sup>115</sup> If the institution has other businesses with the corporation, it is less likely that it will be involved. See Hamdani & Yafeh, *supra* note 63.

trolling shareholder structure), and is heavily influenced by external factors, such as the companies' ownership structure and the legal toolbox.

#### D. The United Kingdom

While the U.K., like the U.S., is characterized by widely held public corporations,<sup>116</sup> shareholder activism is a crucial part of its corporate governance. Financial institutions hold larger portions of the equity of corporations and are more involved in their day-to-day governance than are similar institutions in the U.S.<sup>117</sup> This distinction is partially related to the existence of fewer restrictions on such institutions, but also to the much more empathetic approach to shareholder power taken by U.K. corporate laws.<sup>118</sup> Coinciding with the relatively strong "voice" of shareholders in the U.K. is the relatively higher presence of activism than in the U.S. Nevertheless, higher solicitation costs and ownership requirements limit the participation of minor actors and social reform organizations.<sup>119</sup> Due to their cost, formal shareholder proposals are considered to be a last resort, especially given the ability to influence management on a more informal day-to-day basis.<sup>120</sup>

The U.K. system is similar to that of the U.S. in that activism is, for the most part, a product of economic interest and the use of voting power is the main tool of such activism. However, the U.K. differs from the U.S. in the structure through which this activism takes place, and thus presents a different model. First, it is a constant, repeating, defensive<sup>121</sup> activism that defines the U.K. system, whereas isolated events trigger activism in the U.S. Second, the activism is built on coordination among several institutional players co-carrying the burden of overseeing management, a feature that is virtually non-existent in the U.S.<sup>122</sup> Differences in some of the external factors, including the regulation of financial institutions and shareholder rights, have

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<sup>116</sup> See La Porta et al., *supra* note 111; John Armour, *Enforcement Strategies in U.K. Corporate Governance: A Roadmap and Empirical Assessment*, (ECGI Working Paper No. 106, 2008), <http://ssrn.com/abstract=1133542>.

<sup>117</sup> See Armour, *supra* note 116, at 8, 13.

<sup>118</sup> For example, shareholders can convene special meetings, pass binding resolutions, and discharge directors without cause. See Armour & Cheffins, *supra* note 58; see also Bonnie Buchanan et al., *Shareholder Proposal Rules and Practice: Evidence from a Comparison of the United States and United Kingdom*, 49 AM. BUS. L.J. 739, 800 (2012).

<sup>119</sup> See Buchanan et al., *supra* note 118 (stating that only 2 percent of all U.K. shareholder proposals between the years 2000 and 2006 were social or environmental, as opposed to 30 percent of U.S. proposals).

<sup>120</sup> Buchanan et al. find that the influence of shareholder proposals in improving stock returns (and thus restraining management) is much higher in the U.S. They attribute this effect to the fact the U.K. proposals are seen as a means of last resort reserved for the truly worse firms. See Buchanan et al., *supra* note 118, at 790, 792.

<sup>121</sup> See Berglöf & von Thadden, *supra* note 68 and accompanying text.

<sup>122</sup> There is a contention that hedge funds operate as a wolf pack, but this is much less coordinated than the U.K.'s communicative approach. For a description of the wolf pack strategy, see Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism*, 32 J. CORP. L. 681, 697–98 (2007); William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L. J. 1375, 1379 (2007).

contributed to a significantly different context in which players exert activism. In the U.K., traditional institutions are much more involved, as opposed to the unregulated players that are dominant in the U.S. This is a further divergence in the model employed by activists driven by their economic stake.

### E. Brazil

Brazil's corporate market has seen a unique transformation during the last decade. The country's traditional public markets were crippled<sup>123</sup> due to the lack of reliable outside debt and equity financing for corporations. Corporations were therefore reliant on bank loans, short-term debt, and retained earnings. Political and social developments created a controlling minority structure, in which the main stream of publicly held corporations had voting and non-voting shares, allowing the founders or the controlling family to maintain control while diluting their equity stake in the corporation.<sup>124</sup> Corporate law reforms that were intended to provide protection to minority shareholders and require dual-listing by some Brazilian corporations proved inadequate.<sup>125</sup> Against this backdrop, Brazil's São Paulo stock exchange has embarked upon its own reform by creating a new market.<sup>126</sup> The new market was established as a supplemental market, effectively creating two different corporate governance structures. It is based on the voluntary participation of publicly traded corporations. Among the improved governance mechanisms are a mandatory one share-one vote rule,<sup>127</sup> tag along rights,<sup>128</sup> improved transparency, board independence, and liquidity.<sup>129</sup> The market has also developed contractual mechanisms that are aimed at preventing an outsider

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<sup>123</sup> For a review of Brazil's corporate governance and public markets, see Bernard S. Black, Antonio Gledson de Carvalho & Érica Gorga, *Corporate Governance in Brazil*, 11 EMERGING MKTS. R. 21 (2010).

<sup>124</sup> This was also spurred by a series of tax cuts during the 1960s and 1970s. See Gilson et al., *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the U.S., and the EU* (Stanford Law and Econ. Olin Working Paper No. 390, 2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1541226](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1541226).

<sup>125</sup> See *id.* at 12–13, describing the unsuccessful reforms and mentioning the incompleteness of the dual-listing tool, which allows firms to commit voluntarily to more stringent stock exchange rules. However, the value of voluntary adoption of contractual tools has problems of its own, as only a small portion of Brazilian firms was able to dual-list. See *id.* at 22–26.

<sup>126</sup> See *id.* at 13, describing the German inspiration for this initiative.

<sup>127</sup> See Gilson et al., *supra* note 124, at 15–18, describing the new market rules. One share-one vote rules are considered to be a better shareholder structure because they limit the separation between cash interest and voting power, thus reducing a controlling shareholder's incentive to expropriate corporate resources.

<sup>128</sup> Tag along rights allow minority shareholders to enjoy the same terms a controlling shareholder receives when the latter sells its shares. The rights reduce the controlling shareholder's incentive to engage in transactions that disadvantage minority shareholders. For a review of tag along rights in Brazil, see Morten Bennesen, Kasper Meisner Nielsen & Thomas Vester Nielsen, *Private Contracting and Corporate Governance: Evidence from the Provision of Tag-along Rights in Brazil*, 18 J. CORP. FIN. 904 (2012).

<sup>129</sup> See Gilson et al., *supra* note 124, at 16.

from obtaining a controlling stake without paying a control premium. One such mechanism is the use of shareholder agreements (which under Brazilian law are enforceable and binding upon the corporation<sup>130</sup>) as a way to ensure coordination among shareholders on important matters. The prevalence of these agreements and the support Brazil's corporate law provides them has allowed for the development of an intermediate ownership structure—a peculiar arrangement in developing countries—that is based on multi-blocks of shareholders tied together in a web of shareholder agreements. This structure allows shareholders not only to protect themselves from an outsider trying to gain control, but also to share the costs of monitoring management. The result is better oversight and reduced agency costs. This is an additional model of activism in which pre-commitment by contractual means allows shareholders to maintain their optimal level of shareholdings while simultaneously providing mutual interest and incentive for effective monitoring and, when needed, activism.<sup>131</sup> Another way to interpret this model is through the shift in attention from substance to structure. Shareholders are ensuring a structure that enables optimal levels of shareholdings and optimal levels of activism without committing to the actual nature or substance of the activism itself.

#### F. China

China presents a particularly unique backdrop against which activism takes place. In recent years China has opened its markets to foreign and local investors and has issued shares to the public in many of its previously fully government-owned entities.<sup>132</sup> This process is still ongoing and is characterized by the delicate balance the Chinese government is trying to maintain between the benefits of outside capital and its domestic social agenda. In the initial steps of reform, the Chinese corporate code was reformed and fully owned corporations issued shares to the public. The structure of those issuances was controlled by regulation that created several classes of shares. In particular, most corporations had non-tradable shares—held directly or indirectly by the government—and tradable shares held by the public and foreign investors.<sup>133</sup> The government's controlling ownership can complicate the

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<sup>130</sup> See Black et al., *supra* note 123, at 36.

<sup>131</sup> Note that while this model is similar to the collaborative model of the U.K., it also differs in the sense that the U.K. is more of a loose collaboration model (i.e., ad hoc with no obligation and shifting parties), and the Brazilian model is more of a fixed or stagnant collaboration.

<sup>132</sup> See Donald. C. Clarke, *Corporate Governance in China: An Overview*, 14 CHINA ECON. REV. 494 (2003); Guy S. Liu, *Comparative Corporate Governance: The Experience Between China and the U.K. Corporate Governance*, 13 CORP. GOVERNANCE: AN INT'L REV. 1 (2005); Nandini Rajagopalan & Zhang Yan, *Corporate Governance Reforms in China and India: Challenges and Opportunities*, 51 BUS. HORIZONS 55 (2008).

<sup>133</sup> Chao Xi, *Institutional Shareholder Activism in China: Law and Practice*, 17 INT'L CO. & COM. L. REV. 251, 254 (2006), available at <http://ssrn.com/abstract=938455>. See also

playing field on which activism takes place. The government acting as regulator and as controlling shareholder<sup>134</sup> (in most of the traded firms) is unlikely to provide a comprehensive set of tools for activist minorities, as its interests as controlling shareholder might erode its willingness to regulate for the benefit of minority shareholders.<sup>135</sup> On the other hand, pressure from foreign investors for the provision of some basic minority shareholder protections, such as exit rights and regulation of self-dealing transactions, cannot be ignored if China is interested in increasing its ability to tap foreign capital.

China has several prominent institutional investors, including insurance companies, pension funds, investment banks,<sup>136</sup> securities funds, and foreign investors allowed to trade in the A-share market, often termed as Qualified Foreign Institutional Investors (QFIIs). The involvement of institutional investors in China's capital markets has increased in the last few years.<sup>137</sup>

Ironically, the division between tradable and non-tradable shares by itself has created a powerful tool for minorities to more easily affect share-prices. Since the minority holds the tradable shares while the controlling shareholder holds non-tradable shares, share price is highly influenced by the trading actions of the minority. Because only a small fraction of the total outstanding shares are tradable, a shareholder can influence share price more easily than in other tradable corporations.

It is commonly accepted that if a shareholder is disappointed, he can use the Wall Street rule and vote with his feet. However in China, due to its capital markets' limited liquidity, this action can create a significant negative reaction to share-price and thus provide the shareholder with effective leverage ex-ante.<sup>138</sup> An example of this can be found in the ZTE corporation's

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Michael Firth et al., *Friend or Foe? The Role of State and Mutual Fund Ownership in the Split Share Structure Reform in China*, 45 J. FIN. & QUANTITATIVE ANALYSIS 685 (2010).

<sup>134</sup> See generally Franklin Allen et al., *Law, Finance, and Economic Growth in China*, 77 J. FIN. ECON. 57, 86 (2005).

<sup>135</sup> The government has conflicting interests because it strives to maximize the value of shares it does offer to investors. In comparison to the level of protection twenty years ago, the level of protection to minority investors has improved through a series of reforms. That said, it is the author's opinion that overall, the government has offered suboptimal protection measures to minority shareholders due to two main factors. First, China has strong political interest in maintaining control over its corporations and is therefore not driven only by offering optimal value to interested investors. Second, China has a monopoly in providing minority shares to investors, so it can therefore provide less protective measures for the minority at the requested share price.

<sup>136</sup> In China, investment banks are referred to as "securities companies." See Chao Xi, *supra* note 133, at 252.

<sup>137</sup> See Li Liao et al., *The Value of Shareholder Activism: New Evidence from the Split-share Structure Reform in China 2* (Working Paper, 2008), available at <http://ssrn.com/abstract=1316214>.

<sup>138</sup> Alex Edmans, *Blockholder Trading, Market Efficiency, and Managerial Myopia*, 64 J. FIN. 2481 (2009). Somewhat similarly, Edmans presents a model by which blockholders can exert governance even if they cannot intervene in firms' operations. According to his model, better access to information allows blockholders to signal the market about the long-term prospect of the company by selling or refraining from selling.

attempt to make a cash offer, which resulted in opposition from eleven institutional investors who voted against the offer in the shareholder meeting. The institutions sold their holdings, creating a sudden drop in share price (50%) that forced the corporation to abandon its dual listing plan. China's Security Commission (CSRC) has also promulgated a rule requiring approval of the majority of a company's tradable shares to accept cash offers,<sup>139</sup> and institutional investors have used this to strike down cash-offer proposals.<sup>140</sup> In 2004, the CSRC expanded the protection given to minority shareholders to oppose the majority's action. Tradable shareholder approval is now required for any major transaction affecting tradable shareholders,<sup>141</sup> alongside special disclosure rules and cumulative voting mechanisms.<sup>142</sup>

In recent years, China has initiated reform to its capital markets, particularly to allow for higher liquidity of the capital markets by encouraging firms to converge their split-share structure (tradable and non-tradable) into a single tradable structure. Since a decision in this regard had to be approved by owners of two-thirds of the outstanding tradable shares, the reform provided a valuable means of leverage for institutional investors, not only in extracting added value but also in getting the controlling shareholders' and the board's attention regarding general operational issues.<sup>143</sup>

Overall, China presents yet another model of activism in which activist players can take advantage of transforming and developing economies. These economies suffer from less liquidity and are in need of some structural reforms, giving activists an ability to exert activism through give-and-take negotiations. Chinese activism is uniquely based on the minority's ability to deter controlling shareholders' actions by way of a de fact veto power. When the market for shares is limited and the corporation is interested in share value, the minority's capacity to damage the market price allows for an activist scheme, here labeled market price deterrence.<sup>144</sup>

### G. Australia

Shareholder activism in Australia has been influenced by flourishing union activism. This activism is mainly driven by the one hundred shareholders rule, which allows one hundred shareholders to propose a resolution

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<sup>139</sup> See Xi, *supra* note 133, at 254. This is a concern to tradable shareholders because their equity in the firm is diluted while non-tradable shareholders keep their control.

<sup>140</sup> See Xi, *supra* note 133, at 255. In the case of Foton Motor, nine out of the top ten shareholders were institutional investors and they struck down the proposal.

<sup>141</sup> See Xi, *supra* note 133, at 256. There is an unclosed list of action such as cash offers, rights offers, convertible bond issuances, asset acquisitions, and overseas listing of subsidiaries.

<sup>142</sup> For review of some of the limitations that activists face in China, see Xi, *supra* note 133, at 287.

<sup>143</sup> See Liao et al., *supra* note 137, at 6.

<sup>144</sup> In some cases, the controlling shareholder will not have an interest in share value (e.g., when he has other sources of capital, such as internal or relationship debt). In China, the need for new capital exceeded these internal sources, giving tradable shareholders more leverage.

in the annual general meeting or to convene an extraordinary general meeting. Combined with active “vote no” campaigns among institutional shareholders directed at management proposals, as well as the election of directors, these unions are an influential force in the corporate governance of Australia.<sup>145</sup> The relative ease of access to the general meeting agenda has allowed unions to become active players in Australia, in particular against the backdrop of weakening labor laws and a shareholder-oriented corporate structure.<sup>146</sup> In this legal environment, employees can use the one hundred shareholders rule and their union support to buy a minimal number of shares, creating a shareholders interest group voice and infusing labor concerns into the governance of the corporation. This trend might entail benefits as well as costs.<sup>147</sup> However, as they are in the U.S., shareholders in Australia are precluded from raising resolutions that infringe on the day-to-day business decision-making that is vested with the board of directors.<sup>148</sup> Thus, their influence is limited to structural and general policy matters.<sup>149</sup>

In practice, unions have utilized the one hundred shareholders rule in activist campaigns that they have launched.<sup>150</sup> These efforts did not result in the adoption of the resolutions proposed by unions, but unions have been able to incorporate this tool into a more global campaign that brings the issues into public debate, thereby forcing management to give unions access

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<sup>145</sup> See *Corporations Act 2001* (Cth) SS 249D(1), 249N(1) (Austl.).

<sup>146</sup> See Michael Rawling, *Australian Trade Unions as Shareholder Activists: The Rocky Path Towards Corporate Democracy*, 28 SYDNEY L. REV. 227, 240 (2006); see also Kirsten Anderson & Ian Ramsay, FROM THE PICKET LINE TO THE BOARDROOM: UNION SHAREHOLDER ACTIVISM IN AUSTRALIA 49–52 (2005). For a review of Australian corporate structure, its political roots, and its basic features, see generally Brian R. Cheffins, *Comparative Corporate Governance and the Australian Experience: A Research Agenda*, in KEY DEVELOPMENTS IN CORPORATE LAW AND EQUITY: ESSAYS IN HONOUR OF PROFESSOR HAROLD FORD 13 (Ian Ramsay ed., Butterworths 2002).

<sup>147</sup> For example, potential benefits might include allowing for alignment of shareholders and employee interests, better incentives to monitor, and improved access to information, while costs might include harassing. See Rawling, *supra* note 146, at 244; Anderson & Ramsay, *supra* note 146, at 46–52.

<sup>148</sup> See Harold Ford, Robert Austin & Ian Ramsay, FORD'S PRINCIPLES OF CORPORATIONS LAW 219 (12th ed., 2005); *NRMA v. Parker* (1986) 6 NSWLR 517, 521 (Austl.).

<sup>149</sup> Since many day-to-day decisions have direct impact on the work done by unions, this is a serious restriction on their ability. See Rawling, *supra* note 146, at 246 (noting this is a constraint on unions efforts). It might be claimed that this limitation is similar to the precatory shareholder system of the U.S., but it is important to note that unlike in the U.S., the ability of unions to bring a non-day-to-day topic to vote in Australia has a binding nature, thus providing them with a much more effective tool to voice their interests at the shareholder meeting.

<sup>150</sup> For example, in the Rio Tinto 2000 Campaign, unions proposed two resolutions at the general meeting: first, an appointment of an independent non-executive director, and second, a proposition to adopt a resolution that the corporation would adhere to international labor standards. These two suggested resolutions were linked directly to shareholder value through their connection with the corporation's reputation and ability to generate more revenue. The resolutions received 20.3% support but did not pass. See Anderson & Ramsay, *supra* note 146, at 12–14. The Boral 2003 general meeting, the ANZ general meeting in 2003, and the Blue Scope 2004 general meeting are three similar instances in which improvements of employee welfare were linked to share value. See Anderson & Ramsay, *supra* note 146, at 18, 22, 29.



to high-level decision making and policy making.<sup>151</sup> This form of activism is being used by dual stake agents, particularly employees who are also shareholders and can use their positioning in both arenas to their advantage—both in forming the hundred shareholders group and in obtaining information that might not be otherwise available to shareholders. Labor unions are not alone in their efforts, as the involvement and support of outside stakeholders with general social motives (for example, trade unions) is also a key aspect of the aforementioned activism.<sup>152</sup>

These dual stake activists try to gain support among other shareholders by using issues that are of common interest to both groups and through which they can highlight general shareholder value maximization matters. For example, they may highlight executive remuneration and social issues that can be illustrated to improve shareholder value over the long run.<sup>153</sup>

In sum, Australia presents a model in which stakeholders, rather than pure shareholders, engage in activism. In particular, employees exploit their role as dual agents, using the tools and vernacular of corporate governance to compensate for lack of sufficient protection by labor laws. This activism exemplifies how laws aimed at increasing shareholder voice may be utilized by unexpected players trying to bring about their interests, as cloaked under the governance blanket. Legal changes in the labor protection regime and employees' role as dual players have channeled labor interests into the governance arena. Such activity indicates the possibility of more complex activism in years to come—activism that is not based solely on traditional corporate law interests such as dividend policy, executive compensation and corporate governance policies, but that also utilizes its tools for other ends.

#### H. Japan

Japan has been going through major corporate and capital market reforms in the last decade. Historically, Japan had an ownership structure that was more concentrated, with active involvement of the banking sector in ownership, lending, and promulgating corporations' business direction. Cross-ownership among corporations was widespread as part of the famous

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<sup>151</sup> Again, the binding power of the hundred shareholder rule is a differentiating aspect if we compare social resolutions in Australia with those in the U.S. The binding nature of resolutions adopted in Australia gives social players in Australia better leverage in negotiations with management.

<sup>152</sup> See Rawling, *supra* note 146, at 157.

<sup>153</sup> See Anderson & Ramsay, *supra* note 146, at 3.

Keiretsu,<sup>154</sup> which served as an antitakeover defense and created a business group that provided assistance in several respects to its members.<sup>155</sup>

During the 1990s and 2000s, the power of the Keiretsu declined<sup>156</sup> and, as Japan suffered the “lost decade,” the banking sector lost its grip on its corporate structure. Corporate cross-shareholding patterns have fallen and involvement by foreign investors has increased.<sup>157</sup> This was coupled with (and possibly even drove) corporate governance reforms, including an optional board structure similar to that of the U.S., in which all three committees have a majority of independent directors,<sup>158</sup> providing shareholders with the ability to put resolutions on the company’s agenda.<sup>159</sup> Also, the poison pill was approved as a legitimate tool in the hands of the board.<sup>160</sup>

Against this backdrop, shareholder activism in Japan has also been gaining power in recent years, fueled by both foreign and local players. Heterogeneity can be found not only in the activist players, but also in their tactics. For instance, Steel Partners, a U.S. hedge fund, is known for its confrontational policy, targeting small to midsize firms, taking a large position

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<sup>154</sup> See Yasushi Hamao et al., *U.S.-Style Investor Activism in Japan: The First 10 Years*, 6 (Marshall School of Business Working Paper No. FBE 06-10, 2010) at 8–10; see generally Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895 (1992); Takeo Hoshi, Anil Kashyap & David Scharfstein, *Corporate Structure, Liquidity and Investment: Evidence from Japanese Industrial Groups*, 106 Q. J. OF ECON. 33 (1991).

<sup>155</sup> This group structure also provides business support to its members by sharing knowledge, providing services within the group, and more.

<sup>156</sup> For a review and a dissenting angle on the Keiretsu’s original place, see generally Yoshiro Miwa & J. Mark Ramseyer, *The Fable of the Keiretsu*, 11 J. ECON. & MGMT STRATEGY 169 (2002).

<sup>157</sup> Hamao, *supra* note 154, at 7; Takaya Seki, *Legal Reform and Shareholder Activism by Institutional Investors in Japan*, 13 CORP. GOVERNANCE: AN INT’L REV. 377 (2005); Kenichi Osugi, *What is Converging? Rules on Hostile Takeovers in Japan and the Convergence Debate*, 9 ASIAN-PAC. L. & POL’Y J. 143 (2007).

<sup>158</sup> Traditionally, Japanese boards were very large and hierarchical. As there was no separation of officers and directors, becoming a director was merely another promotion for senior managers, and directors generally retained “line” responsibilities for a department or division of the corporation. An overhaul of Japan’s corporate law in 2002 provided for the adoption of an American-style board committee system with audit, nominating, and compensation committees and a system of executive officers. Under this board system, American-style institutions replace the two key German-inspired features of Japanese corporate governance: representative directors are replaced by executive officers with authority to bind the corporation and internal auditors are replaced by the board’s audit committee. See generally Ronald J. Gilson & Curtis J. Milhaupt, *Choice as Regulatory Reform: The Case of Japanese Corporate Governance*, 53 AM. J. COMP. L. 343 (2005); Seki, *supra* note 157, at 379–81.

<sup>159</sup> The combination of the recession and an inflow of foreign capital has led to reforms in the “employee for life” structure and the activism of shareholders. Shareholders can present their own proposal if they hold more than 1 percent or 300 shares. Also, in the transitional model they set the dividends, auditors and compensation to directors. The reform allowed the board to move to the three-committee structure of the U.S. (nomination, compensation and audit) and directors can decide on dividends and compensation. Most Japanese firms still have a board of auditors that is elected by shareholders. Pension funds in Japan are starting to act like CALPERS. The gradual decline in cross shareholders and institutional activism is putting the traditional Japanese notions to the test. See Seki, *supra* note 157.

<sup>160</sup> However, the poison pill is exercised with some limitations. See Hamao, *supra* note 154, at 51.

in such targets, and then pressuring management to dispense of free cash flows.<sup>161</sup> Similarly, Yoshiaki Murakami, a former Japanese government official, has used several funds to launch aggressive share purchases and hostile takeovers.<sup>162</sup> This form of activism abandons internal corporate governance mechanisms and instead utilizes the capital markets as a lever of activism. It could be referred to as a self-imposing activism.<sup>163</sup> On the other hand, East Asian funds followed a different route, choosing instead to engage in relationship-driven activism whereby they gain access to top executives and work with them to improve governance and operations. An empirical survey has found that a large majority of activist funds accumulating stakes of more than five percent hold their shares for more than two years. This longer-term holding pursues the relationship-based activism approach described above.<sup>164</sup>

Japan's pension fund association (PFA) is another intriguing player. Similarly to its U.S. equivalent, the California Public Employees' Retirement System (CalPERS), PFA is one of the major activist players but its tactics stand in sharp contrast to the confrontational model employed by its U.S. counterpart. PFA has more objective<sup>165</sup> guidelines for its proxy vote. It engages in informal communications with portfolio corporations and focuses on praising<sup>166</sup> firms with good corporate governance rather than attacking firms that suffer from poor corporate governance. This constructive activism model is based on cherry picking examples of good governance to educate the public, investors, and firms as to how governance should be. This model is based on an underlying belief in market forces, i.e., that rather than attempting to fix the bad apples, an activist should show the market which firms are the good ones.<sup>167</sup>

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<sup>161</sup> This is beneficial because taking a large stake is particularly efficient in light of shareholders' power to replace board members without cause under Japanese law. See Osugi, *supra* note 157, at 161.

<sup>162</sup> See Hamao, *supra* note 154, at 14–16.

<sup>163</sup> Instead of relying on legislative mechanisms, this activism relies on ownership, the basic building block of corporate law.

<sup>164</sup> Hamao, *supra* note 154.

<sup>165</sup> See Bruce E. Aronson, *Japanese CalPERS or a New Model for Institutional Investor Activism? Japan's Pension Fund Association and the Emergence of Shareholder Activism in Japan*, 7 N.Y.U. J. L. & Bus. 571, 616 (2011) (describing the PFA's activities). With regard to its voting strategy, the PFA relies on performance-related benchmarks, such as three straight years of losses and no dividend payout or five years of cumulative losses (the "3/5 performance rule"), and violations of law or other matters of corruption that had large impacts on the company during the director's term.

<sup>166</sup> *Id.* at 620–21 ("The PFA's positive emphasis on promoting good corporate governance rather than criticizing bad corporate governance is epitomized by its antithesis of CalPERS' focus list: its corporate governance fund. Established in March 2004 and managed by Nomura Asset Management, the purpose was to create a portfolio of the approximately 50 companies with the best corporate governance practices out of the more than 1,500 companies listed in the first section of the Tokyo Stock Exchange in order to 'send a message' to corporate managers . . .").

<sup>167</sup> Indeed a possible argument would state that the important market players or sophisticated investors are already well informed and that an efficient capital market should reflect this. However, market players might invest for different reasons and thereby create noise as to the governance component of a company's performance. By highlighting better-governed cor-

Japan is a remarkable example of the way different models of activism can co-exist under the same exogenous conditions. Further study of the Japanese system could provide valuable information by examining how the division of power among these models has shifted over time against the backdrop of recent governance reforms. Such study could provide insight into the interaction between changes to the regulatory environment and activism.

### I. Italy

Italy's corporate ownership structure can be described as family-owned with the use of multiple pyramids and ownership structures that amplify the agency costs between minority and majority shareholders.<sup>168</sup> Alongside economic reforms as a byproduct of European harmonization, recent years have brought about an increasing interest by foreign investors. Specifically, Italy has passed several amendments and reforms to its corporate law aimed at improving its corporate governance mechanisms.

In 2003, Italy reformed its corporate law, entrusting the board with the majority of decision-making powers and responsibilities. However while the board of directors is vested with significant powers,<sup>169</sup> shareholders still have significant voting power on various matters. Among them are approval of the balance sheet and dividends, election of internal and external auditors, and compensation of directors and auditors.<sup>170</sup> One of the main aspects of reform was a move from mandatory rules to an enabling approach, allowing shareholders to shape and tailor their own corporate governance provisions.<sup>171</sup>

Despite reforms toward greater flexibility in corporate governance, the prevalence of controlling shareholders within Italian corporations has necessitated the retention of mandatory provisions protecting minority shareholders. Among these provisions are the ability to convene a special meeting,<sup>172</sup>

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porations, this noise is minimized, allowing for both sophisticated investors and average individuals to avoid the costs of monitoring poorly run corporations. In addition, there is value to public opinion, and by highlighting these corporations, pressure is put on institutional investors to invest in these firms or explain why they refrain from investing in these firms.

<sup>168</sup> These structures allow the controlling shareholder to separate voting power from financial ownership. This in turn exacerbates the agency cost between minority and controlling shareholders. Matteo Erede, *Governing Corporations with Concentrated Ownership Structure: Can Hedge Funds Activism Play Any Role in Italy?* 3 (CLEA Annual Meeting Paper, 2009), available at <http://ssrn.com/abstract=1397562>.

<sup>169</sup> *Id.* at 17.

<sup>170</sup> *Id.* at 17–18. The above-mentioned powers are in addition to regular powers vested in shareholders, including electing directors and dissolution, among others.

<sup>171</sup> Marco Ventoruzzo, *Experiments in Comparative Corporate Law: The Recent Italian Reform and the Dubious Virtues of a Market for Rules in the Absence of Effective Regulatory Competition* 3–4 (Bocconi Legal Studies, Research Paper No. 06-02, 2004), available at <http://ssrn.com/abstract=556601>.

<sup>172</sup> Art. 2367 Codice Civile [C.c.] in G.U. 1942, n.72 (It.) (10% of shareholders can convene a special meeting.).

to add a topic to the general meeting agenda,<sup>173</sup> to challenge shareholder's decisions,<sup>174</sup> to file a derivative suit,<sup>175</sup> and to file complaints with the board of auditors or the courts.<sup>176</sup> Since 2007, minority shareholders must also elect at least one member of the board of directors and one member of the board of auditors.<sup>177</sup>

Against this backdrop, it is not surprising that Italy's main activists are hedge funds, both local and foreign.<sup>178</sup> However, the model of activism employed by hedge funds in Italy is different in some respects from the model in the U.S. due to its controlling shareholder structure, the agency costs the activists try to mitigate, and the different legal environment in which Italy's hedge funds operate. Contrary to hedge funds in the U.S., hedge funds in Italy cannot rely on the threat of a takeover or the launch of a proxy fight as a stick to wield against management. Instead, they have to utilize their improved minority rights as leverage for gaining cooperation. In many cases, activist hedge funds seem to be passive, often siding with the controlling shareholder and supporting its suggested list of minority representatives on the board. This helps the passive-active shareholder to gain relational access to management and the controlling shareholder. This model, which this paper terms participatory activism, is aimed at getting a seat at the table rather than turning it over.

Yet in other cases, as when the relationship route fails, some hedge funds do resort to more aggressive tactics by going directly and openly against the controlling shareholder, leading public campaigns, and trying to sway other shareholders, the public, and regulators against management.<sup>179</sup>

<sup>173</sup> Art. 126-bis Decreto Legislativo 24 febbraio 1998, n. 58 (It.) (2.5 percent of shareholder support allows shareholders to add an item to a convened meeting.); Art 2379 and Art 2377 C.c. in G.U. 1942, n.72 (It.) (Shareholders are allowed to challenge shareholder decisions in court if the decision is of dubious legality. For other decisions 0.1% of shareholders is required to challenge the measure in court.).

<sup>174</sup> Art. 2393 C.c. in G.U. 1942, n.72 (It.) (The required threshold is 2.5 percent.).

<sup>175</sup> Art 2408 C.c. in G.U. 1942, n.72 (It.) (Complaints that are filed by 2 percent of the shareholders require an immediate response by the board of auditors.).

<sup>176</sup> Erede, *supra* note 168, at 22–23.

<sup>177</sup> See generally Erede, *supra* note 168, at 27–28 (“The total gross assets collected and managed by the Italian hedge funds have been steadily growing topping more than 30 billion Euros in February 2008 . . . According to a survey published by *ILSole24Ore* (Italy's most prominent financial newspaper), the weight of the investments made by the nine major hedge funds and mutual funds doing activism in some Italian listed companies has significantly increased in 2007 reaching a total value of more than 2.2 billion euros—about \$3.5 billion—at the end of February 2008.”).

<sup>178</sup> Erede, *supra* note 168, at 37–39, 41 (describing the following: the FNM case, in which campaigns of hedge funds sought a distribution of dividends from a local railroad company operating in Northern Italy; the BPM case, in which the governor of the Italian central bank sent a letter urging the adoption of governance reforms after a loud campaign by a consortium of hedge funds; and the Parmalat case, in which a hedge fund operator attempted to amend Parmalat's by-laws in order to increase a dividend distribution—all examples in which activist hedge funds have used the media, other shareholders, and regulators to promote their cause).

<sup>179</sup> See Michael Bradley & Anant Sundaram, *The Emergence of Shareholder Value in the German Corporation* (EFA 2004 Maastricht Meetings, Paper No. 1467, 2003), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=463840](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=463840); but see Sigurt Vitols, *Changes in*

## J. Germany

Germany, as part of a movement that is taking place throughout the E.U., has seen significant changes to its corporate law in recent years. The traditional influence of banks,<sup>180</sup> while still strong, is at least by some accounts in decline,<sup>181</sup> and there is increased interest by foreign investors in German corporations. Germany's corporate governance, including its shareholder activism, is still very much shaped by the unique legal backdrop governing corporate law.

Germany's codetermination governance structure allows labor to have a substantial voice in the corporation, and decisions made by the supervisory board are often a product of compromise.<sup>182</sup> Ownership structure is usually based on several main blockholdings in the range of thirty percent ownership, and banks still play a substantial role in the corporate landscape, both as creditors and as shareholders.<sup>183</sup>

Against this backdrop, activism in Germany takes place on several different fronts. First, banks play a major role as activists. They are direct owners of some shares and have voting power in custodial shares<sup>184</sup>—a combination that allows them to place significant portions of nominees on the supervisory board and thus influence the composition of the management board. In some respects, banks act as guardians of shareholders as a group. Given the rational apathy of small shareholders, the banks' ability to vote their shares allows them to hold management in check on the one hand, but simultaneously raises concerns of empty voting.<sup>185</sup> Second, rights of minority shareholders in the shareholders' meeting also play an integral part in facilitating activism—any shareholder can add proposals to existing items<sup>186</sup> and five percent of the shareholders can add new items or call for an extraordinary (special) meeting.<sup>187</sup>

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*Germany's Bank-Based Financial System: Implications for Corporate Governance*, 13 CORP. GOVERNANCE: INT'L REV. 386, 386–96 (2005).

<sup>180</sup> See generally Klaus J. Hopt & Patrick C. Leyens, *Board Models in Europe – Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France and Italy*, 1 EUR. CO. & FIN. L. REV. 135 (2004).

<sup>181</sup> See Patrick C. Leyens, *German Company Law: Recent Developments and Future Challenges*, 6 GERMAN L. J. 10 (2005) at 1415. See generally Gary Gorton & Frank A. Schmid, *Capital, Labor, and the Firm: A Study of German Co-Determination*, 2 J. EUR. ECON. ASS'N 863 (2004).

<sup>182</sup> See Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L. J. 1927, 1938 (1993).

<sup>183</sup> See Hopt & Leyens, *supra* note 180, at 143, 168.

<sup>184</sup> *Id.* at 143.

<sup>185</sup> Since banks vote custodial shares in which they have no economic interest, they might favor their position as debt holders over their position as shareholders and exercise their voting power accordingly. For a discussion regarding the concerns empty voting might create in the hedge fund context, see Hu & Black, *supra* note 8.

<sup>186</sup> See Peter Cziraki et al., *Shareholder Activism Through Proxy Proposals: The European Perspective*, 16 EUR. FIN. MGMT. 738, 744 (2010).

<sup>187</sup> Although the debate on the effectiveness of shareholders proposals as a monitoring tool is still vibrant, recent studies tend to conclude that capital markets perceive proposals as a

Interestingly, unlike in the U.K. and the U.S., where capital markets perceive shareholders' proposals as positive feedback<sup>188</sup> (presumably reflecting active monitoring), in Germany—and continental Europe in general—the same shareholder initiatives and proposals are met with a negative reaction in the stock markets.<sup>189</sup> This reaction might be attributed to the signal that these proposals convey. Since minority shareholders in a controlling shareholder structure have less impact on management's actions, capital markets perceive the proposals more as an S.O.S. sign of the minority and less as a true effort to bring about the desired change.<sup>190</sup> This, in turn, actually provides minority shareholders with an effective tool to engage privately with the controlling shareholder and the management, holding the threat of a proposal that would hurt share value as leverage in such conversations.

Germany also has a unique provision allowing shareholders to bring a lawsuit in court to challenge decisions taken in the general meeting, allowing shareholders to use this right as leverage against the controlling shareholder and management.<sup>191</sup> This tool has been used by aggressive hedge funds. For instance, hedge fund Paulson & Co. purchased shares in Celanese, a German chemical manufacturer, after Blackstone launched a takeover bid. Paulson & Co. then used litigation to prevent (or more accurately, delay) its squeeze-out from the corporation until it was able to get more favorable terms from Blackstone.<sup>192</sup>

While the full form of the U.S. derivative suit is not available to activist shareholders, shareholders in Germany who hold one percent of the shares can file a suit against the members of the management board or the supervisory board on behalf of the corporation.<sup>193</sup> In these derivative suits, the suing

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positive sign. See Cziraki et al., *supra* note 186, at 7; see also John M. Bizjak & Christopher J. Marquette, *Are Shareholder Proposals All Bark and No Bite? Evidence from Shareholder Resolutions to Rescind Poison Pills*, 33 J. FIN. & QUANT. ANALYSIS 499 (1998); Yonca Ertimur et al., *Board of Directors Responsiveness to Shareholders: Evidence from Shareholder Proposals*, Working Paper (2008); Randall S. Cotter & James F. Cotter, *Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction*, 13 J. CORP. FIN. 368 (2007).

<sup>188</sup> See Cziraki et al., *supra* note 186, at 33 (finding that proposals are perceived as governance concern).

<sup>189</sup> See Udo C. Braendle, *Shareholder Protection in the USA and Germany – "Law and Finance" Revisited* (Germany Working Papers in L. & Econ., No. 18, 2006), available at [http://www.germanlawjournal.com/pdfs/Vol07No03/PDF\\_Vol\\_07\\_No\\_03\\_257-278\\_Articles\\_Braendle.pdf](http://www.germanlawjournal.com/pdfs/Vol07No03/PDF_Vol_07_No_03_257-278_Articles_Braendle.pdf); Sandra K. Miller, *Minority Shareholder Oppression in the Private Company in the European Community: A Comparative Analysis of the German, United Kingdom, and French Close Corporation Problem*, 30 CORNELL INT'L L.J. 381 (1997); Bernd Singhof & Oliver Seiler, *Shareholder Participation in Corporate Decision-Making Under German Law: A Comparative Analysis*, 24 BROOK. J. INT'L L. 493 (1998).

<sup>190</sup> See Cziraki et al., *supra* note 186, at 741.

<sup>191</sup> See Marco Becht et al., *Hedge Fund Activism in Europe* 19 (Working Paper, 2010), available at <http://ssrn.com/abstract=1616340>.

<sup>192</sup> *Deutsch AktG* [German Stock Corporation Act], Sept. 6, 1965, BGBI. I at 1089, Sec. 148.

<sup>193</sup> This tool has been used twice in practice. See LG München [District Court of Munich], ZIP 2007, 1809 and Oberlandesgericht München [Higher Regional Court of Munich] ZIP 2008, 73.

shareholders bear the risk of litigation costs and they must succeed in a preliminary court procedure intended to prevent shareholders from bringing abusive derivative actions.<sup>194</sup>

Even more interestingly, the German code has established a unique institution, the special representative (*besonderer Vertreter*), which is a potential tool for activist shareholders, albeit one that is unused in practice.<sup>195</sup> The special representative is appointed at the shareholder meeting by the shareholders and has the function of enforcing claims for damages against members of the management board (*Vorstand*) or the supervisory board (*Aufsichtsrat*), allowing shareholders to force an investigation and a suit against the company or any of its organs. Another function of the special representative is that, according to recent case law, a special representative can be appointed to assert claims against a controlling shareholder.<sup>196</sup> When a special representative is appointed for this purpose, the controlling shareholder's voting rights are excluded in the shareholder meeting electing the special representative.<sup>197</sup> Thus, the special representative can potentially become an instrument of the minority shareholders and activist players.

Germany's models of activism are not made out of one mold. Banks act as activists, and as in Australia, they are dual agents acting as both shareholders and debt holders. With the significant representation of other, non-bank stakeholders in German corporations, including employees and bond holders,<sup>198</sup> minority shareholders, particularly new foreign investors, are expected to make more frequent use of the aforementioned formal rights that shareholders have as a means of exerting pressure on the corporation.

### K. France

France's corporate law and markets have been transforming from an environment with mainly family oriented firms with weak capital markets, weak banks, and high governmental involvement in regulation to a more diffuse market as privatization has trended up over the last fifteen years.<sup>199</sup>

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<sup>194</sup> See Paul A. Carsten, *Derivative Actions under English and German Corporate Law – Shareholder Participation between the Tension Filled Areas of Corporate Governance and Malicious Shareholder Interference*, 7 EUR. CO. & FIN. L.R. 98 (2010); Braendle, *supra* note 189, at 272–73; Kaal A. Wulf & Richard W. Painter, *Initial Reflections on an Evolving Standard: Constraints on Risk Taking by Directors and Officers in Germany and the United States*, 40 SETON HALL L. REV. 1433, 1472–73 (2011).

<sup>195</sup> Landgericht München [Munich District Court I], ZIP, 1809 (2007).

<sup>196</sup> *Id.*

<sup>197</sup> This is because the controlling shareholder faces a conflict of interest that may prevent him from voting in the best interest of the corporation. See Oberlandesgericht München, ZIP 2008, 73.

<sup>198</sup> Wulf & Painter, *supra* note 194, at 1455–56.

<sup>199</sup> Compare *Privatisation in the 21st Century: Recent Experiences of OECD Countries*, ORG. FOR ECON. COOPERATION AND DEV. 6 (2009), available at <http://www.oecd.org/daf/cal/corporategovernanceofstate-ownedenterprises/48476423.pdf>, with James Fanto, *The Role of Corporate Law in French Corporate Governance*, 31 CORNELL INT'L L. J. 32, 39–40 (1998); see also Alexander Marquardt and Ellen H. Clark, *French Privatizations and International*



French corporate governance is particularly interesting due to the complexity and myriad options that the corporate code offers. French law enables three different board structures: one-tiered, two-tiered, and two-tiered with a separation between the CEO and chairman of the board.<sup>200</sup> Generally, after the corporate reform France underwent in 2001,<sup>201</sup> shareholders have maintained strong formal and participatory rights. These rights include the right to inspect the books and voice rights at the general meeting<sup>202</sup> as well as the power to remove the board without cause.<sup>203</sup> In addition, the French code provides minority shareholders with an effective veto power: management resolutions receiving more than one-third dissenting votes are blocked (*minorité de blocage*).<sup>204</sup> As to voting rights, proxy voting has been introduced to the legal system,<sup>205</sup> prompting questions as to the validity of voting dormant shares in support of the management;<sup>206</sup> a suggestion has been made to

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*Capital Markets*, 15 NW. J. INT'L L. & BUS. 408 (1994) (describing the two waves of privatization, the first of which occurred between 1986 and 1987, when sixty-five corporations were designated for privatization). Among the corporations privatized during the first privatization wave were Saint-Gobain, Paribas and Compagnie General d'Electricité. The second wave took place between 1993 and 1997 (after the republicans regained power).

<sup>200</sup> See Klaus J. Hopt & Patrick C. Leyens, *Board Models in Europe – Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France and Italy*, 1 EUR. CO. & FIN. L. R. 135, 156 (2004).

<sup>201</sup> See Girard's description of the major reforms that allowed for better involvement of minority shareholders; among these are the introduction of mail proxy and the lowering of thresholds for invoking shareholder's rights. Carine Girard, *Comparative Study of Successful French and Anglo-Saxon Shareholder Activism* 12, 19 (Eur. Fin. Mgmt. Ass'n. Paper 150, 2009), available at <http://lead.univ-angers.fr/~granem08/IMG/pdf/CGirard.pdf>.

<sup>202</sup> Among these rights: Mandatory right to participate at the General assembly; Right to convene a special meeting for any shareholder holding more than 5% of the shares and in cases of "emergency" a single share; Right to submit written questions for any shareholder; Right to ask for addition of a topic of order for shareholders holding 0.5%-5%, depending on the market value of the firm; Right to challenge or ask for revocation of audit reports by a 5% shareholder; and a right to present questions regarding the management actions/operations to the chairman of the *directoire* or of the *conseil d'administration*, (if the shareholder controls 5% of the capital—solely or as a group). If these questions are not answered within one month, a right to ask for the designation of a management expert arises. This expert can analyze the management of the corporation and present the management's actions of the corporation. See CODE DE COMMERCE [C. COM.] L225-113, 103, 108, 105, 230, 233, 231, 232 and 251, respectively; see also Dirk A. Zetsche, *Shareholder Interaction Preceding Shareholder Meetings of Public Corporations – A Six Country Comparison*, 2 EUR. CO. & FIN. L. R. 107 (2005).

<sup>203</sup> Article L225-18 to the code de commerce says that the general assembly can remove the board of directors and the chairman at all times. Article L225-61 to the code de commerce further states that the general assembly and the members of the supervisory board (*conseil de surveillance*) can remove directors with cause. See CODE DE COMMERCE [C. COM.] L225-18 and 61, respectively.

<sup>204</sup> See Girard, *supra* note 201, at 12.

<sup>205</sup> See Carine Girard, *Shareholders' Activism: A Comparison Between the United Kingdom and France*, available at <http://www.u-bourgogne.fr/LEG/wp/1001201.pdf> at 10.

<sup>206</sup> In practice, blank proxies (*pouvoirs en blanc*) reduce active participation by shareholders. The U.S. is familiar with this issue, as management can sometimes get blank votes in its favor by the vote of institutional investors. The code of ethics of AFG (Association Française de Gestion Financière) advises active participation at the general assembly. [http://www.afg.asso.fr/index.php?option=com\\_content&view=article&id=98&Itemid=87&lang=en](http://www.afg.asso.fr/index.php?option=com_content&view=article&id=98&Itemid=87&lang=en).

install independent representatives to vote these blank proxies.<sup>207</sup> Under French law, the relatively prevalent direct and derivative suits leave directors with higher liabilities, as their duty of care cannot be waived or indemnified by the corporation.<sup>208</sup> They could also be held personally liable criminally or in bankruptcy.<sup>209</sup>

The market for corporate control is limited by the duty to disclose percentage holdings and by the double voting power given to shareholders who are long term (more than two years), as codified in the charter or by a shareholders' meeting.<sup>210</sup> Similarly to its Italian counterpart, French corporate governance has seen some significant reforms in the last decade.<sup>211</sup> One of the recent developments in the corporate governance of listed companies is the introduction of the Principles for Corporate Governance (*Principes de gouvernement d'entreprise*) of October 2003.<sup>212</sup> These mandatory provisions stipulate the necessary qualifications of directors with respect to their skills and to their independence.<sup>213</sup> They require that half of the board,<sup>214</sup> a majority of the directors on the compensation committee, and two-thirds of the directors on the audit committee be independent.<sup>215</sup>

One particularly interesting vehicle of shareholder activism is the minority shareholders' association (*Les associations d'actionnaires*).<sup>216</sup> According to Article L225-120 of the French commercial code,<sup>217</sup> shareholders of public corporations who hold their shares for at least two years and who hold at least five percent of the voting rights, with some modification based on

<sup>207</sup> See Loi 2005-845 du 26 juillet 2005 de sauvegarde des entreprises [Law 2005-845 of July 26, 2005 on Safeguards of Enterprises], JOURNAL OFFICIEL DE LA REPUBLIQUE FRANCAISE [J.O.] [OFFICIAL GAZETTE OF FRANCE], January 1, 2006.

<sup>208</sup> *Id.* It is important to state that unlike other countries, the threat of director liability in France is legitimate and there have been several instances in which directors were determined liable. See *You're Not in Delaware: Directors' Liabilities in Major European Countries*, 3 Debevoise & Plimpton Private Equity Report 12, 21–23 (2003) (also referencing the 1990s case of Nasa Electronique S.A., a leading French case concerning directors' liabilities. The French court found that the one-tiered board of directors was aware of questionable management decisions and did nothing to prevent them. Directors were all held jointly and severally liable for a damages amount in excess of FF 400 million; Helen Anderson, *Directors' Liability for Corporate Faults and Defaults – An International Comparison* 42 (Workplace and Corp. L. Research Group Working Paper, 2008), available at <http://digital.law.washington.edu/dspace-law/bitstream/handle/1773.1/518/18PacRimLPolyJ1.pdf?sequence=1>.

<sup>209</sup> See CODE DE COMMERCE [C. COM.] L225-96.

<sup>210</sup> See CODE DE COMMERCE [C. COM.] L225-96.

<sup>211</sup> See *supra* notes 201 and 202 and accompanying text.

<sup>212</sup> European Corporate Governance Institute, *Principes de gouvernement d'entreprise résultant de la consolidation des rapports conjoints de l'AFEP et du MEDEF de 1995, 1999 et 2002* (October 2003), [http://www.ecgi.org/codes/documents/cg\\_oct03\\_fr.pdf](http://www.ecgi.org/codes/documents/cg_oct03_fr.pdf).

<sup>213</sup> *Id.*

<sup>214</sup> *Id.*

<sup>215</sup> *Id.* at 7–10.

<sup>216</sup> See Dirk A. Zetzsche, *Shareholder Interaction Preceding Shareholder Meetings of Public Corporations – A Six Country Comparison*, 2 EUR. COMPANY & FIN. L. 107, 134–35 (2005).

<sup>217</sup> See also CODE DE COMMERCE [C. COM.] L225-103, L225-105, L225-230, L225-231, L225-232, L225-233 and L225-252.

the total outstanding capital of the firm,<sup>218</sup> may form associations to represent their interests in the company.

L'association de défense des actionnaires minoritaires (ADAM) is one of the most renowned shareholders' associations in France and one of twenty active organizations of its type.<sup>219</sup> Created in 1991, the association's goal is to protect the collective interests of shareholders.<sup>220</sup> Among its members<sup>221</sup> are private individuals and large institutional investors.<sup>222</sup> The association employs an attorney who files suits on behalf of its members.<sup>223</sup> Although plans are in place to allow for class actions in 2014,<sup>224</sup> because the French legal system does not have a class action mechanism, each plaintiff must be named.<sup>225</sup> Currently, ADAM provides shareholders a substitute for the class action mechanism,<sup>226</sup> which can be a powerful voice for relatively small shareholders by reducing the free rider problem<sup>227</sup> and the limitations on coordination that its American counterparts face.<sup>228</sup> By engaging the COB (Commission des Opérations de Bourse, the French equivalent of the SEC),

<sup>218</sup> CODE DE COMMERCE [C. COM.] L225-120 (required percentage is dependent on the market value of the firm; for firms with value exceeding 15 million euros, the required percentage is only 1%).

<sup>219</sup> See Girard, *supra* note 201 at 8, describing the success and stature that ADAM and its founder, Colette Neuville, have gained in France.

<sup>220</sup> See *Association of Minority Shareholders*, SCHUMANN BOURSE, [http://archive.wikiwix.com/cache/?url=http://www.schumann-bourse.fr/articles/bourse\\_actionnaire%2520minoritaire.htm](http://archive.wikiwix.com/cache/?url=http://www.schumann-bourse.fr/articles/bourse_actionnaire%2520minoritaire.htm) (last visited Oct. 6, 2013).

<sup>221</sup> It is estimated that there are over 5,000 ADAM members. *Id.* For more background, see Judith Lerner, *Colette, Adam and Goliath*, THE GUARDIAN (Apr. 13, 2002), available at <http://www.theguardian.com/money/2002/apr/13/shares.moneyinvestments> (profiling the organization).

<sup>222</sup> Lerner, *supra* note 221.

<sup>223</sup> For instance, the association's first victory was in 1991, when Colette Neuville, the founder of the association, obtained 84 million euros in compensation for members as a result of Tuffier's bankruptcy. In 1998, ADAM contested the practical details of the takeover of Havas and obtained 1 billion euros in compensation from Havas. See *Association of Minority Shareholders*, *supra* note 220.

<sup>224</sup> See Christine Gateau & Alpha Diallo, *France: Introduction of Class Actions Expected in Early 2014*, LEXOLOGY (Nov. 6, 2013), <http://www.lexology.com/library/detail.aspx?g=5e105cf6-9818-432b-a26d-95df828a1c7d>.

<sup>225</sup> *Class Actions in France: Coming Soon?*, JONES DAY PUBLICATIONS (2013), available at <http://www.jonesday.com/class-actions-in-france-coming-soon-08-30-2013>.

<sup>226</sup> See Girard *supra* note 201, at 6–7.

<sup>227</sup> Indeed, in some instances these associations are financed with membership fees and, thus, the free rider concern is still relevant with respect to those shareholders who are not members of the association. However, membership in such associations allows groups of shareholders to share the costs of monitoring and thus reduces the instances in which free riding would prevent monitoring from happening ex-ante.

<sup>228</sup> U.S. proxy rules have strict limitations on coordination between groups of shareholders and thus limit the likelihood of formation of such associations. For a description of U.S. proxy limitations, see Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States*, THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 459–65 (Peter Newman, ed., 1998); Ronald J. Gilson et al., *How the Proxy Rules Discourage Constructive Engagement: Regulatory Barriers to Electing a Minority of Directors*, 17 J. CORP. LAW. 29, 30–31 (1991–1992); Norma M. Sharara & Anne E. Hoke-Witherspoon, *The Evolution of the 1992 Shareholder Communication Proxy Rules and Their Impact on Corporate Governance*, 49 BUS. LAW. 327, 328–29 (1993–1994).

these associations have proven to be effective activists by using the relatively strong formal rights of shareholders, lobbying, and effectively using the willingness of courts to provide remedies.<sup>229</sup> More recently, these associations have also joined efforts with foreign activists. For example, ADAM has worked in coordination with two hedge funds to bring about changes in a target corporation.<sup>230</sup>

At the same time, France has also been experiencing a movement toward what ADAM's founder, Carine Girard, describes as a global model.<sup>231</sup> The increased presence of local and foreign institutional investors as part of the privatization process has helped to bring about professionalization in the activism process. Among other factors, France has experienced higher levels of involvement by activist hedge funds and an emergence of proxy advisory firms.<sup>232</sup>

French law has given minority or dispersed shareholders strong formal rights through the internal mechanisms of the corporation (i.e. voice at the general assembly) and a more stringent legal environment for directors and managers. It has also encouraged, or at least enabled, these shareholders to form organizations that make the implementation of these rights more feasible.

### L. Summary

The examples described above illuminate the large disparities between different models of shareholder activism. The next section will move from the analytical model that was developed and illustrated so far and will contend that this new taxonomy has direct relevance to policy makers in contemplating governance reform.

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<sup>229</sup> For example, ADAM challenged the terms of an agreed takeover bid by the French electrical maker, Schneider Electric, of a local rival, Legrand. The deal was already approved by the French financial market regulator (CMF) when ADAM claimed the bid included an unreasonably low price for Legrand's minority non-voting preference shareholders. ADAM took the case to the Court of Appeal in Paris and won, forcing Schneider Electric to increase its buy-out offer by 55 euros per share. See The Guardian, *supra* note 221. Similarly, after a new criminal ruling against Natixis, 730 Natixis shareholders sued the company in commercial court and were awarded 4.5 million euros in damages. See Anne de Guigné, "Nouvelle Action en Justice Contre Natixis," LE FIGARO, available at <http://www.lefigaro.fr/societes/2010/01/05/04015-20100105ARTFIG00478-nouvelle-action-en-justice-contre-natixis-.php>.

<sup>230</sup> See Girard, *supra* note 201, at 9, describing the joint effort of two hedge funds and ADAM at the general meeting of Atos Origin.

<sup>231</sup> Girard, *supra* note 201, at 17.

<sup>232</sup> See Girard, *supra* note 201, at 17. Proxy advisory firms include OPCVM, Proxinvest, AFG, and Deminor.

## V. INTRODUCING A COMPREHENSIVE TAXONOMY: POLICY IMPLICATIONS

A. *Preliminary Implications*

As shown, different models of activism can coexist under the same exogenous conditions (as in the U.S.). Thus, public debate focusing only on specific forms might neglect other forms, whether they already exist or might be introduced as a consequence of regulatory changes. This could lead to undesirable regulatory changes catering to only a specific model of activism while unintentionally influencing other models.

The understanding that activism is not homogeneous is particularly crucial in current U.S. debate, where discussion and proposed reforms primarily focus on the narrow topic of hedge funds' activism.<sup>233</sup> However, any suggested reform pertaining to the ways we increase or restrict shareholders' power to be active in corporate affairs should first identify the potential benefits it is trying to promote. The suggested reform should then identify and target which forms of activism might be relevant and which groups and interests are most likely to serve these purposes.

The financial crisis has highlighted the problems with taking a rigid approach to shareholders' power. Many of the recent calls to regulate the hedge fund industry and to limit shareholders' power are based on the assertion that financial institutions are driven to take excessive risks as a result of shareholders' pressure and incentive-based compensation.<sup>234</sup> However, this approach ignores the differences between the various kinds of shareholders inside a corporation as well as their divergent short and long-term interests. While some shareholders may be market players who come and go as share prices change, many others are holding shares for the long run and thus are more concerned with long term stability and profit. Reform in financial institutions should strive to empower the latter group at the expense of the former rather than to uniformly limit all shareholders' power.

The aforementioned framework—examining models, motives, and tools rather than specific forms of activism—and an effort to deconstruct activism into different spectra are important features that any public debate must consider.

B. *Different Levers of Influence*

Deconstructing activism into different observable parameters also provides an important practical tool for policy makers. Rather than focusing on Band-Aid solutions to particular concerns that specific forms of activism

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<sup>233</sup> Introducing foreign models may impact other institutions or goals, so there may be costs related to making necessary modifications to other rules and legislation as well as the cost of such models' administrative implementation.

<sup>234</sup> See generally *supra* note 8 and accompanying text.

create, this taxonomy provides better clarity as to the means a policy maker has in regulating activism. Since a policy maker cannot regulate the motives of market players in performing activism, two levers remain for adjustment when considering reforms.

First, lawmakers can focus on direct regulation of activists, identifying which types of activists (whether currently existent or potentially dormant) are harmful, which are beneficial, and which are beneficial only under specific conditions. This analysis in turn can provide policy makers with answers as to which forms of activism should be restricted by direct regulation and which forms should actually be incentivized to act. After such an analysis is performed, lawmakers should not only implement negative regulation that limits forms of damaging activism, but also positive regulation that provides incentives to desired players to take part as activists and thus facilitate beneficial activism. This will also help limit the potential for alternative damaging activists to fill the void created by restrictions on current activists.

Second, a policy maker can make adjustments to the regulatory environment that will provide (or limit) tools and incentives to activists, thus shifting its focus from direct regulation to incentive-based regulation. A regulator can tinker with the means activists can employ, removing damaging options or adding means that beneficial activists are likely to use. A regulator can provide monetary subsidization to beneficial activist actions while penalizing damaging activities. This approach is advantageous because it focuses on the type of action instead of the type of player performing it.

In addition, a regulator can facilitate changes in the financial environment as a whole. For instance, building better capital markets or opening them to foreign competition might bring about change in the type of activism dominating that country. On the same note, moving from a government-owned structure or from a controlling shareholder structure to a more diffuse ownership structure can bring about similar changes to the activists operating in that country.

In sum, this paper's taxonomy is not only important as a theoretical matter; it also has crucial implications as a practical matter. Disentangling activism from populism and ad hoc approaches is crucial to any policy reform discussion. By using this new taxonomy and examining the different forces acting, the equilibrium between these forces, and the levers that can change such balance, a policy maker will be better equipped to make changes to the corporate governance regime.

### *C. From Theory to Practice: The Importance of Comparative Examination While Considering Reform*

This paper has provided a framework for a policy maker approaching regulatory change. However, while a policy maker can identify types of activities that are desired or harmful, it is almost impossible to fully predict

how a new equilibrium will be manifested once one of these aforementioned levers is used.

Maybe the most crucial and subtle point this paper has raised against current debate is that a Band-Aid regulation trying to fix specific activist players' actions (e.g. hedge funds) might end up as both too specific and too general. These arrangements can be too specific, by fixating on one model of activism rather than the spectra of possible models, and too general by potentially adopting solutions that are not tailored to the specific equilibrium of activism. A comparative look over time can provide us with insight to possible solutions while also revealing how implementing specific changes might influence such equilibrium.

#### *D. Tying It All Together – Practical Implications*

The above analysis has established that different models of activism exist. A policy maker can use direct and indirect regulation to create a different mix of activists and models at any given point in time, allowing him to move along the spectra of activism. A full description of activism consists not only of a survey of current activist players, but it also accounts for potential players that are currently dormant in the current regulatory equilibrium. These players could very much come to life under the slightest change to a jurisdiction's exogenous factors.

Hence, focus should be centered both ex-ante on the procedural manner in which the policy maker goes about passing a reform and ex-post on examining procedures and ensuring that they give sufficient account to the various models. Shifting focus between the specificity of a measure and the broader procedural framework provides more probative indications of the extent to which a proposed reform has truly considered regulatory tools' impact on both reform targets and other models of activism.

##### *1. Three Leveled Structural Process*

When a policy maker contemplates reform with a clear goal, the process should consist of three levels. First, the policy maker should compose a list of existing activist groups operating within the country and the desired effect the reform should have on these groups. More importantly, the policy maker should also assess whether there are potential groups that are dormant at the moment (and whether they are good or bad from the reform's goal standpoint) that might become active as an outcome of a reform. This assessment should utilize historical research that tracks past forms of activism within the country and looks at models in other countries to assess their relevance after the proposed reform took place. As the second step, the policy maker should delineate alternative models for achieving the policy goal by gathering information on models that exist in other countries and the potential and feasibility of importing them.

As a third step, only after information has been gathered in steps one and two on the potential players affected by a reform (present or dormant) and the potential ways to bring about the change (both domestic and foreign), the policy maker should engage in a cost-benefit analysis that estimates which measures are most likely to achieve the goal of the reform in the most efficient way. In this analysis the policy maker will take into consideration both negative measures (designed to limit activity of damaging players) and positive measures (designed to incentivize the activity of contributing players). The policy maker will also weigh the likelihood of introducing new harmful players against that of introducing beneficial players. Finally, the policy maker should account for the cost of adopting foreign models.<sup>235</sup>

Engaging in this three level analysis allows the policy maker to be positioned in an optimal spot to perform a cost-benefit analysis process, having information about current players and potential tools to carry out such reform but also about additional players and tools that might be relevant to such reform. This process would ensure that policy makers are not missing crucial elements of the equation: absent players and tools that may be beneficial when composing a policy.

## 2. *Current Reforms and Public Debate Are Too Broad and Too Narrow*

As noted above, the emergence of high profile activists like hedge funds has led to warranted debate as to the desired level of their involvement in governance. However, many calls for regulatory changes, sparked by high profile events such as the Apple or Herbalife examples mentioned above, are currently construed both too narrowly and too widely: too narrowly, by targeting specific actors, such as hedge funds, without carefully accounting for other models of activism that could or should be impacted by such reform; and too widely, by the growing tendency of calls to import specific arrangements from other jurisdictions without considering the full spectra of models of activism. Below, the paper tackles three reforms in corporate governance by demonstrating their over-broadness and over-narrowness while also providing insight as to how outcomes could have been different if the paper's argument were adopted.

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<sup>235</sup> For example, Bebchuk and Jackson claim that adoption of more stringent 13D rules would create excessive costs in preventing activists from gaining meaningful influence over potential targets. See Bebchuk & Jackson, *infra* note 246.



### 3. SEC Proxy Reform

The proxy reform passed by the SEC in 2010,<sup>236</sup> although later repealed by a D.C. federal court,<sup>237</sup> provides a notable example of the importance of applying the above-described framework to amending corporate governance rules. The SEC's process for evaluating and passing the proxy reform failed to take into account the existence of different models or the need to account for equilibrium changes.

The U.S. proxy reform as adopted by the SEC in August 2010 came after years of discussions and was aimed at allowing shareholders a greater voice in corporate affairs.<sup>238</sup> Prior to passing the reform, the SEC considered several proposals, heard from proponents and opponents of the reform, and eventually elected to modify the rules to include the nominees of significant, long-term shareholders in the company's proxy materials alongside the nominees of management. In its formal rule release, the SEC described the goals of the reform at length,<sup>239</sup> the cost-benefit analysis, and the outcome of this analysis. Notably absent from the SEC's process, however, were the first two phases of the structural process described above: identification of all the different potential players and identification of all the different tools of activism. The SEC reforms appear to have been driven by then-current activist players (e.g., hedge funds, social activists) and not by the potential introduction of new players. As demonstrated below, the solution used by the SEC ignores some other viable options and models in existence around the world.

The final report of the SEC (and the reform itself) is goal driven – it aims to improve the board of directors' accountability by making it easier for shareholders to replace board members.<sup>240</sup> In other words, the SEC was in-

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<sup>236</sup> See Press Release, SEC, SEC Adopts New Measures to Facilitate Director Nominations by Shareholders (Aug. 25, 2010), available at <http://www.sec.gov/news/press/2010/2010-155.htm>.

<sup>237</sup> *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

<sup>238</sup> A discussion of the SEC proxy reform is not within the scope of this Article. In short, the final rules adopted by the SEC are comprised of two main rules: (1) Rule 14a-11, which would require a publicly-traded company to include in its proxy materials a candidate nominated by shareholders that have held shares representing at least three percent of the voting power of the company's stock for the past three years; and (2) Rule 14a-8(i)(8), which, as amended, would require companies in certain circumstances to include shareholder proposals regarding director nomination procedures in their proxy materials. Facilitating Shareholder Director Nominations, Securities Act Release No. 33,9136, Exchange Act Release No. 34,62764, Investment Company Act Release No. 29384, 75 Fed. Reg. 56668, 56743–48 (Sept. 16, 2010) (to be codified at 17 C.F.R. pt. 200, 232, 240, 249).

<sup>239</sup> See Press Release, *supra* note 236.

<sup>240</sup> In the report, the SEC deals with other tools of activism:

We are aware, of course, that the new rules are additive to many existing means of monitoring and 'disciplining' a company's board and management, which include: Hostile takeovers; stockholders 'voting with their feet' by selling their shares; board members being replaced by other means when the company's stock performance is poor; and management turnover following poor performance or wrongdoing.

SEC: Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56668, 56763 (Sept. 16, 2010) (to be codified at 17 CFR pts. 200, 232, 240 & 249). While the report proceeds to

terested in facilitating more activism by shareholders and chose to modify its proxy rules to allow for the achievement of this goal.

The report is extensive in its review of the different views and options for the reform, but, ironically, it is also very narrow in scope. Instead of exploring more options to achieve the above-mentioned goal of improving activism, the SEC was focused only on one mechanism – the proxy rules. Throughout the report, there is scant discussion of alternative ways of achieving this goal or of the impact such a reform would have on shareholder activists themselves. Would the reform introduce new activist players? If so, would these players be successful in achieving the underlying goal of the reform? Should the regulatory framework account for these new players through rules facilitating or limiting their actions? Does the reform endanger some positive activists? And if so, should accompanying rules incentivizing these players be drafted? These questions are left unanswered in the report.

The report not only fails to address the reform's impact on activists themselves, but it also neglects to address the interaction between this new reform and existing tools. Moreover, it lacks a thorough discussion as to whether there are other tools that could achieve similar goals with fewer costs.<sup>241</sup>

How could the above-mentioned framework change the final outcome? An option raised in the SEC discussions leading to the proposed reform would allow groups of shareholders to join their holdings and thereby achieve the requisite threshold of three percent to be eligible to nominate candidates on the company's ballot. This format, allowing shareholders to form coalitions, is not novel and is prevalent in other countries. Therefore, it would have been prudent to pay attention to the landscape in the countries allowing for such coalitions and to consider some of the prevailing mechanisms accompanying this option. For instance, the SEC has acknowledged the importance of group formations to achieve the three percent threshold. The Commission did not, however, develop any exhaustive account of the potential formation of shareholder associations (as they have developed elsewhere), nor of the ability to utilize or limit these potential associations as a complement to the ability to join holdings in U.S. reform. As reviewed above, France has similar rules allowing shareholders to join their shareholdings, and these rules have led to the formation of shareholder associations as a complement to the legal ability to join shares. The SEC should have considered whether the introduction of such organizations would be beneficial

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explain that the added value of the reform necessitates its adoption, it does not engage in a true effort to survey both current and possible means of achieving the underlying goal of accountability of the board and how the reform interacts with these possibilities.

<sup>241</sup> For instance, if we believe hedge funds will take advantage of proxy access and extract private benefits from management by threatening the nomination of their own candidates, perhaps we should limit the amount of time during which a shareholder can nominate directors (thereby limiting repeated players from extracting such benefits).

or harmful in the context of the U.S. and should have taken action to facilitate or regulate such bodies as part of the reform.

Another example of a missing consideration is evident in the three percent threshold set in the reform. The SEC deals with questions as to why the threshold is three percent (rather than five percent or one percent) and also with questions as to whether the threshold should have been adjusted in accordance with a company's size and type of shareholdings. Again, while this paper will not address the merits of the SEC's arguments, the SEC's discussions lack an examination of whether the threshold should have been varied based on the type of shareholder involved. Instead of looking at shareholders as a unified group, the SEC should have considered that different types of shareholders might merit different thresholds. Should institutional investors face the same thresholds (three percent and holding requirements) as hedge funds? Should non-profit activists be bundled with investment banks? Is there a need to incentivize specific groups of shareholders? Might other groups' use of this tool warrant cause to worry? Perhaps, instead of a percentage of shareholdings, there should be a set number of shareholders (that could include a requirement for specific types of shareholders) similar to the Australian provision. The answers to such questions are complex, so while a uniform threshold may in fact be the right solution, an alternative scheme may better serve the goal of reform. In its cost-benefit analysis, the SEC should have deconstructed activism into the three spectra discussed in this paper. Furthermore, the agency should have thoroughly discussed the motives and nature of current and potential activists before setting the threshold.

Indeed, the regulatory process's lack of true exploration of the different options and corresponding costs did not escape judicial review. The SEC reform was largely struck down by a federal court, which held that "[b]y ducking serious evaluation of the costs that could be imposed upon companies from use of the rule by shareholders representing special interests, particularly union and government pension funds, we think the Commission acted arbitrarily."<sup>242</sup>

#### 4. *Contemplated Changes to SEC Rules Regarding Section 13(d) Reporting Rules*

In March 2011, the law firm Wachtell, Lipton, Rosen & Katz petitioned the SEC to modernize the blockholder reporting rules under Section 13(d) of the Securities Exchange Act of 1934. This has sparked another debate centering on the potential need for reforms and the importance of a comparative understanding of shareholder activism.

The petition sought:

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<sup>242</sup> *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

[T]o ensure that the reporting rules would continue to operate in a way broadly consistent with the statute's clear purposes, and that loopholes that have arisen by hanging market conditions and practices since the statute's adoption over forty years ago could not continue to be exploited by acquirers, to the detriment of the public markets and security holders.<sup>243</sup>

Specifically, the petition advocated for more strict disclosure duties of blockholders, reducing their ability to trade on shares after crossing the five percent threshold without disclosure from ten days to one business day. The petition specifically referred to shareholder activists that can currently take advantage of the ten-day window to accumulate positions well above five percent before making any public disclosures. The petition references similar changes made by foreign jurisdictions, such as the U.K., Germany, Switzerland, Australia and Hong Kong, as compelling reasons for a change. Action taken in these jurisdictions was used to show that such change is workable and to advocate that the U.S. does not lag behind other nations.<sup>244</sup>

In response to the petition, a scholarly paper by Professors Lucian Bebchuk and Robert Jackson has attacked the petition's underlying contention that improvements in the digital era coupled with abuse of the rule by activist hedge funds merit a change in current rules.<sup>245</sup> The authors question the petition's claim by pointing to a recent study that suggests the tail end of the ten-day window is not actually being used for significant trading activity in practice.<sup>246</sup> The authors stress the invaluable role of blockholders in constraining management's potential mismanagement and the potential impact that a rule change might have on their activities.<sup>247</sup>

The proponents of a rule change have referenced other jurisdictions' shorter disclosure windows as persuasive evidence that the U.S. is lagging behind and should follow suit. Bebchuk and Jackson correctly pointed out that one cannot infer the desirability of adopting specific arrangements from foreign jurisdictions without first considering the overall legal treatment of the activist player whose actions are to be regulated by the rule.<sup>248</sup> The argument stressed in Bebchuk's and Jackson's paper parallels the argument promoted in this paper. The adjustment of legal arrangements should be a byproduct of the existence of activist actions that are perceived as potentially harmful. The changes should also reflect the extent to which they interact with other legal arrangements in fostering or limiting harmful actions and

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<sup>243</sup> Letter from Wachtell, Lipton, Rosen & Katz to Elizabeth M. Murphy, Secretary, U.S. Sec. & Exch. Comm'n (Mar. 7, 2011), File No. 6-424, *available at* <http://www.sec.gov/rules/petitions/2011/petn4-624.pdf>.

<sup>244</sup> *Id.*

<sup>245</sup> See Lucian A. Bebchuk & Robert J. Jackson, *The Law and Economics of Blockholder Disclosure* 2 HARV. BUS. L. REV. 39, 55 (2012).

<sup>246</sup> *Id.* at 47–51.

<sup>247</sup> *Id.* at 58.

<sup>248</sup> See N.Y. Stock Exchange Rule 452, 1996 WL 34424015.

account for the potential implications of these changes on other players. Though the tendency to point to specific legal arrangements or changes in foreign jurisdictions is becoming increasingly common among practitioners and legislators, such suggestions cannot be made in isolation from the complete set of legal arrangements then in place. Moreover, they cannot be made without examining the potential impact the arrangement suggested for transplant would have within the activism context in the target transplant jurisdiction.

### 5. NYSE Changes to Rule 452 Governing “Broker Non-Votes”

The NYSE’s Rule 452 governs when NYSE member organizations, acting as brokers by holding customer securities in “street name” accounts, may vote on proxy matters without specific client instructions. In the past, the NYSE has allowed brokers to vote uninstructed shares on certain types of corporate governance proposals, particularly when company management supported the proposal in question, but this is no longer the case. In memo number 12-4 from January 25, 2012, the NYSE announced that it would reclassify corporate governance proxy proposals (e.g. proposals to declassify boards) as “Broker May Not Vote” matters.<sup>249</sup>

NYSE Rule 452 authorizes NYSE member brokers to use their discretion and cast votes on behalf of “street name” shareholders who do not return their proxy card to the broker within ten days of the shareholders’ meeting. The Rule prohibits brokers from voting those uninstructed shares on “non-routine” matters. Routine matters, according to Rule 452, include any matter where the action to be taken is (i) adequately disclosed to the shareholders and (ii) does not include authorization for a merger, consolidation or any other matter which may substantially affect the rights or privileges of the stock.

In order to more clearly define the scope of Rule 452, the NYSE has developed a procedure whereby each meeting will be designated by an appropriate symbol to indicate one of the following: (a) members may vote a proxy without instructions of beneficial owners; (b) members may not vote specific matters on the proxy; or (c) members may not vote the entire proxy. In addition, the supplementary notes to Rule 452 set out a non-exclusive list of twenty-one types of proposals on which a NYSE member broker is prohibited from voting in the absence of instructions from the retail shareholder.<sup>250</sup>

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<sup>249</sup> N.Y. Stock Exchange Info. Memo No. 12-4, *Application of Rule 452 to Certain Types of Corporate Governance Proxy Proposals*, [http://www.nyse.com/nyseinfo/memos/detail?memo\\_id=12-4](http://www.nyse.com/nyseinfo/memos/detail?memo_id=12-4).

<sup>250</sup> Exchange Proxy Rules for Member Organizations, NYSE Listed Company Manual, [http://nysemanual.nyse.com/lcm/Help/mapContent.asp?sec=lcm-sections&title=sx-ruling-nyse-policymanual\\_402.06&id=chp\\_1\\_5\\_2\\_6](http://nysemanual.nyse.com/lcm/Help/mapContent.asp?sec=lcm-sections&title=sx-ruling-nyse-policymanual_402.06&id=chp_1_5_2_6).

In acknowledgement of the requirements set forth in the Dodd-Frank legislation, NYSE amended Rule 452 to prohibit brokers from exercising discretionary voting in all director elections and on all matters related to executive compensation.<sup>251</sup> These changes are now part of the non-exclusive list of twenty-one proposals. In 2012, the NYSE further amended its enforcement of Rule 452 and has indicated that certain corporate governance proposals will now be considered as “May Not Vote” matters. The NYSE issued the following explanation:

In light of recent congressional and public policy trends, broker voting of uninstructed shares has fallen into increasing disfavor and the matters on which brokers may vote uninstructed shares has narrowed over recent years . . . In light of the attention on broker voting, the NYSE has reexamined its treatment of certain proposals under NYSE Rule 452. As a result, certain types of corporate governance proposals on company proxy statements that the NYSE had previously ruled “broker may vote” matters will be treated as “broker may not vote” matters going forward. Examples of these proposals include: proposals to de-stagger the board of directors, majority voting in the election of directors, eliminating supermajority voting requirements, providing for the use of consents, providing rights to call a special meeting, and certain types of anti-takeover provision overrides.<sup>252</sup>

Rule 452 allows brokers to vote shares when they have no voting instruction. In the past two years, the exceptions to this general rule have grown. First, a change to the rule itself was made to designate executive compensation and election of the board as named matters in which the general rule would not apply. Second, the NYSE, without making an actual change to the rule, notified its members that it would interpret Rule 452 more narrowly. It will now cease including questions of corporate governance within the Rule’s boundaries.

This new policy further cements the argument that current changes to activism regulation are construed both too specifically and too generally. Some shareholders have a tendency to be apathetic toward proxy requests and subsequently ignore them. In modifying the rule, the NYSE has responded to the general concern that if brokers are allowed to vote with management and without instructions from the beneficiary owners, then management might be able to pass resolutions that are against general shareholder interest.

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<sup>251</sup> See N.Y. Stock Exchange Info. Memo No. 10-36, *Dodd-Frank Impact to Proxy Voting Requirements*, 2010 WL 3066238.

<sup>252</sup> Judith C. McLevey, *Corporate Governance Proxy Proposals & Rule 452*, EXCHANGES (Jan. 25, 2012, 1:51 PM), <https://exchanges.nyx.com/judy-mclevey/corporate-governance-proxy-proposals-rule-452>.

However, the NYSE change was too broad. While the Exchange's concern has some merit, this change to the Rule has also made some desirable governance changes near impossible. In many cases, amending the corporate charter is necessary to make changes to the governance of the corporation. Shareholders must approve such change by voting on a management-submitted proposal. When changes to the charter require a supermajority vote, inability to vote uninstructed shares might block proposals that entrench management, as the rule change seems to address, but it might also block proposals that have been promoted and requested by shareholders themselves. Such a result gives the passive investor veto power on a variety of issues that may improve share value. This concern is further amplified when juxtaposed with e-proxy reform in the U.S., which allows companies to direct shareholders to a website instead of sending them printed proxy materials. This reform resulted in a decrease in voting by retail investors, further reducing the likelihood of achieving the required quorum for adopting desirable changes.<sup>253</sup>

That the NYSE failed to consider the entire playing field, adopting a rule spurred by general public perception without considering the entire model of activism, serves as another example of regulatory changes structured too broadly. At the same time, the rule change was also too narrow. An examination of voting arrangements in other jurisdictions where brokers and banks play a significant role could have led to a more nuanced rule aimed at reducing management entrenchment while allowing for desirable corporate changes. For example, the NYSE could have looked to Germany and Austria, where the Stock Corporation Code permits a custodian bank to obtain a standing proxy (for a maximum of fifteen months) from the shareholder, thereby allowing the custodian bank to vote at its discretion.<sup>254</sup> Allowing shareholders to give general "may-vote" instruction to brokers instead of a broader mandate could have created a more flexible safety valve and allowed important changes to take place. Similarly in France, the board of directors (or the managing board) is allowed to distribute an *en blanc* proxy, allowing the president of the annual general meeting to cast a vote "in favor of the adoption of resolution proposals approved by the board of directors (or the managing board) and against the adoption of all other resolution proposals."<sup>255</sup> The NYSE could have mitigated its concern that brokers would act against their beneficial owners' interest by including a box in the proxy

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<sup>253</sup> See Fabio Saccone, *E-Proxy Reform, Activism, and the Decline in Retail Shareholder Voting* (The Conference Board Director Notes No. DN-021, 2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1731362](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1731362) (analyzing voter response data from the 2009 and 2010 proxy seasons).

<sup>254</sup> See Theodor Baums, *Shareholder Representation and Proxy Voting in the European Union: A Comparative Study*, Conference on Comparative Corporate Governance, Max-Planck-Institut für Ausländisches und Internationales Privatrecht (May 15–17, 1997), <http://www.jura.uni-frankfurt.de/43029609/paper53.pdf>.

<sup>255</sup> *Id.* at 10.

allowing broker discretion, thereby permitting shareholders to avoid the cost of gathering information while empowering their brokers to act in their names.

### *E. Potential Context Related Critique*

In recent years, comparative research has been widely used in the context of activism. Interest groups and academics alike acknowledge the globalization of activism and have begun to highlight specific arrangements in other jurisdictions as a basis for similar changes in the U.S. This is precisely one of this paper's main points. A comparative review is not meant to provide normative conclusions as to the desirability of one system over the other, nor is it meant to provide a conclusion on the desirability of one specific governance tool over the other. Specific observations of a country's legal structure, both in letter and in practice, are influenced by innumerable factors, many of which are often heavily linked to the model of activism employed in each jurisdiction. A call for the narrow adoption of a specific arrangement without a clear understanding of the model as a whole would lead to undesirable outcomes.

## VI. CONCLUSION

The common view of shareholder activism encompasses shareholders trying to influence corporate affairs.<sup>256</sup> However, current legal scholarship has paid little attention to the way different shareholders, all driven by varying motives and using different means, interact and why such interaction is important. This paper has argued that the lack of robust discussion of the existence of different models of activism in academic and public debate can lead to inefficient legal reforms. Regulatory changes that are motivated by the actions of specific actors might inadvertently restrict the expansion of efficient models or forms of activism while enabling the development of inefficient models.

The paper's proposed new taxonomy, which views activism as composed of three main elements – motive, type, and exogenous factors – will help in tackling activism, both in assessing its merits as well as in reforming policy. Specifically, the paper highlights the potential shortfalls of existing treatment of activism and how the aforementioned taxonomy could be used

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<sup>256</sup> See William Q. Judge et al., *Antecedents of Shareholder Activism in Target Firms: Evidence from a Multi-Country Study*, 18 CORPORATE GOVERNANCE: AN INT'L REV. 258, 259 (2010) (“[activism is] the use of ownership position to actively influence company policy and practice. Shareholder activism can be exerted through letter writing, dialogue with corporate management or the board, asking questions at open sessions in general meetings, and through the filing of formal shareholder proposals.”) (quoting Emma Sjöström, *Shareholder Activism for Corporate Social Responsibility: What Do We Know?*, 16 SUSTAINABLE DEV. 141, 142 (2008)).



to prevent regulatory changes that are too specific, addressing concerns stemming from a specific manifestation of activism without accounting for the effects of such changes on other actors, while also refraining from the adoption of arrangements that do not take into account the specific attributes of the regulated system.

By viewing activism through the proposed framework, the paper advocates a treatment of shareholder activism that should promote a more nuanced discourse by regulators, market participants and academics.