commentators have characterized hedge fund activism as fundamentally hostile to managers, we find that hedge fund activists are openly hostile in less than 30 percent of cases (hostility includes a threatened or actual proxy contest, takeover, lawsuit, or public campaign that is openly confrontational). More commonly, hedge fund activists cooperate with managers, at least at the initial stages of their intervention, and achieve all or most of their stated goals in about two-thirds of all cases. Managerial opposition to hedge fund activism may stem from its negative impact on CEO pay and turnover even if it ultimately creates value for shareholders.

Our findings have important implications for the policy debate about hedge fund activism. Although some prominent legal commentators, including leading corporate lawyers and European regulators, have called for restrictions on hedge fund activism because of its supposedly short-term orientation, our results suggest that activist hedge funds are not short-term holders. Activists also appear to generate substantial value for target firm shareholders. Indeed, our evidence of the market's positive response to hedge fund activism, and the subsequent success of activists, challenges the premises of proposals requiring increased hedge fund regulation.

For policy makers, our paper shows important distinctions between the role of hedge funds and other private institutional investors such as private equity firms. Despite their frequently aggressive behavior, activist hedge funds do not typically seek control in target companies. The median maximum ownership stake for the entire sample is about 9.1 percent. Even at the 95th percentile in the full sample, the stake is 31.5 percent—far short of the level for majority control. Activists rely on cooperation from management or, in its absence, support from fellow shareholders to implement their value-improving agendas. This explains why hedge fund activists tend to target companies with higher institutional holdings and analyst coverage, both of which suggest a more sophisticated shareholder base. It is also common for multiple hedge funds to coordinate by cofiling Schedule 13Ds (about 22 percent of the sample) or acting in tandem without being a formal block. Although some regulators have criticized such informal block behavior as anticompetitive, coordination among hedge funds can benefit shareholders overall by facilitating activism at relatively low individual ownership stakes.

The new evidence presented in this paper suggests that activist hedge funds occupy an important middle ground between internal monitoring by large shareholders and external monitoring by corporate raiders. Activist hedge funds are more flexible, incentivized, and independent than internal monitors, and they can generate multiple gains from targeting several companies on similar issues. Conversely, activist hedge funds have advantages over external corporate raiders, because they take smaller stakes, often benefit from cooperation with management, and have support from other shareholders. This hybrid internal-external role puts activist hedge funds in a potentially unique position to reduce the agency costs associated with the separation of ownership and control.

Fiduciary Duties for Activist Shareholders*

IMAN ANABTAWI and **LYNN STOUT**

[W]e believe that the law of fiduciary duty is uniquely suited to address the growing problem that opportunistic shareholder activism poses for corporate governance. To this end, we propose concrete recommendations for furthering this doctrinal evolution.

Fiduciary Duties of Shareholders

[F]iduciary duties are usually applied to officers and directors. In some cases, however, courts impose fiduciary duties of loyalty on certain types of shareholders as well.... In particular, courts have held that majority shareholders, like corporate officers and directors, owe a fiduciary duty of loyalty to minority shareholders that precludes them from using their positions as controlling shareholders to extract material economic benefits from the firm at the minority's expense.... Any use to which they put the corporation or their power to control the corporation must benefit all shareholders proportionately.

The Conflicted Shareholder

When we speak of conflicts of interest between shareholders, we do not intend to describe simple disagreements over business strategy.

Similarly, we do not intend to capture honest disagreement about the proper purpose of the corporation.

The analysis changes dramatically, however, when a shareholder stands to capture a personal economic benefit, not captured by other shareholders, by promoting a particular corporate outcome. Such situations can be directly analogized to interested transactions by corporate officers and directors.

Below, we briefly survey some of the most common and substantial economic conflicts that have arisen between activists and other minority shareholders in modern public firms.... Far from sharing homogenous interests, minority shareholders often find themselves at economic odds with each other, and the sources of conflict are increasing.

[A]s minority investors in public companies have acquired more power, it has become clear that an activist minority may also have enough clout to push through interested transactions.

The high profile proxy battle to remove Steven Burd as Chairman and CEO of Safeway, Inc., provides [a] thought-provoking example of the many ways activist investors can use their shareholder status to push for favorable treatment in their other dealings with the firm. Burd was

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taking a hard-line stance in labor negotiations with the United Food & Commercial Workers Union, which represents grocery workers. He argued that Safeway needed to lower its labor costs to compete with non-unionized chains like WalMart. The California Public Employees' Retirement System (CalPERS), a large pension fund representing California employees, organized a proxy campaign to remove Burd from the corner office. It was soon revealed that the CalPERS campaign had been initiated by CalPERS' President, Sean Harrigan, who was also a career labor organizer and an official of the United Food & Commercial Workers' Union. Burd survived the attempt to oust him after it was widely reported that the grocery workers' union was using CalPERS as a stand-in in its battle with Safeway over pay and benefits.

The risk of self-dealing has long been recognized in the context of freeze-out mergers arranged by controlling shareholders. But shareholders can enter into various other corporate dealings, including stock repurchases, employment contracts, and consulting and advisory agreements, that constitute interested transactions.

Conflicts of interest between activists and other shareholders in the firm can also arise when activist shareholders take "adverse positions" in derivatives or in securities issued by other companies.... [The authors provide several examples involving "empty" voting as discussed in the Hu and Black excerpt.—Ed.]

Yet a third source of conflict between shareholders in public firms ... is the increasingly complex capital structure of American corporations.... The potential for conflict between holders of different classes of securities has multiplied enormously. What's more, activist investors, especially hedge funds, have learned that they can profit from such conflict by taking positions in two different types of securities issued by the same corporation, and using the control rights associated with one type of security to increase the economic value of their holdings in the other type.

Finally, we turn to a source of investor conflict that has received considerable recent attention, the conflict between short-term investors who plan to sell their shares within days or months, and longer-term investors who hold their securities for years or decades. The possibility of conflicts between these two types of investors is easy to understand.... The result, it has been suggested, is short-term activists pressuring managers to pursue policies that raise share price in the short term but fail to help the company, and even harm it, in the long term.

Toward a General Theory of Shareholder Fiduciary Duties

[C]onventional analysis treats shareholder fiduciary duties as exceptional in nature, with shareholders generally presumed to be free to pursue their self-interest except when they exercise a degree of control over the firm equivalent to that of the corporation's directors. An observer so inclined could interpret case law even more narrowly, restricting controlling shareholders' fiduciary obligations to just freeze-outs and closely held corporations.

We believe that such a restrictive reading is neither necessary nor wise. Instead, we propose that all shareholders, like all directors and officers, be viewed as owing latent duties to the firm and their fellow shareholders. These latent duties would be triggered whenever a particular shareholder—whether or not it is technically a shareholder capable of controlling the boards' decisions as to all matters—in fact manages to successfully influence the company's actions with regard to a particular issue in which that shareholder has a material, personal economic interest.

Our suggested approach has two principal components. First, shareholder fiduciary duties would not, as it is now, be triggered by a particular shareholder's ability to direct corporate decisionmaking in the abstract, but rather by that shareholder's ability to influence the outcome of a particular corporate decision in which it has a personal conflict of interest. This change in level of analysis—from the general corporate level to the level of a discrete issue—defines the idea of "control" more expansively to account for the reality that modern shareholders can influence corporate policy through a variety of strategies that do not require them to control a numerical majority of the firm's voting shares. Thus, we would say that a shareholder "controls" corporate conduct whenever its action is a determinative, or "but for," cause of the particular corporate decision in issue.

Second, we take the position that the duty of loyalty should be activated by *any* factual situation—including, but not limited to, freeze-outs and closely held corporations—in which a shareholder seeks to promote a corporate strategy or transaction in which that particular shareholder has a material, personal pecuniary interest. This approach recognizes that, while shareholder conflicts of interest are perhaps most obvious in freeze-outs and closely held corporations, they can arise in a host of other situations as well, including conflicts over merger strategies, special dividend declarations, and stock repurchases.

Our proposal may at first appear a radical reconception of shareholder fiduciary duty. We believe, however, that it is in fact a natural extension of basic corporate law principles, as well as faithful to the underlying purposes of fiduciary doctrine.

The balance of corporate decisionmaking power between managers and shareholders is shifting rapidly in the direction of shareholders. If that shift is to prove beneficial—if the move toward greater "shareholder democracy" is to increase shareholder value rather than destroy it—it must not take place without limitation. Rights must be coupled with responsibilities, and the common law doctrine of shareholder fiduciary duty is especially well suited to meet this challenge.

Expanding the Notion of Control

The key question is what form and degree of control over the corporation must a shareholder exercise to trigger fiduciary duties.

The inquiry into whether or not a shareholder has control for purposes of activating the latent duty of loyalty is, accordingly, best framed as an inquiry into whether a particular shareholder can, formally or informally, influence corporate behavior with respect to a particular issue. ... Any attempt to exercise influence that produces the desired result—put differently, any shareholder act that is a "but for" cause of some corporate transaction or strategy—is an exercise of *de facto* shareholder control.

This formulation goes beyond the scope of the traditional shareholder control test in two important ways. First, it is context-specific, meaning it determines whether a shareholder is a controlling shareholder by referring to the role that the shareholder played with respect to a particular corporate decision. If a minority shareholder influences a particular corporate action, such as a decision to declare an extraordinary dividend, in a determinative way, it will have satisfied the control test with regard to that specific action.

A second, related distinction between our definition of shareholder control and the existing test is that our formulation does not rely on the sort of arbitrary threshold for voting power that underlies current doctrine. Contemporary case law automatically deems a shareholder "controlling" if it has the right to vote a majority of the company's outstanding shares.... In contrast, our test would treat even a 1 percent shareholder as controlling if that shareholder's assent were essential in determining the outcome of the vote at issue. Moreover, our formulation recognizes that minority shareholders can exercise control even when they are not voting. For example, a shareholder may be able to determine a board's decision with regard to a particular matter—say, a share repurchase program—by threatening a proxy battle, or by undertaking an aggressive public relations campaign directed at the board. This is a favorite tactic of hedge fund managers.

Expanding the Notion of Shareholder Conflicts of Interest

In addition to expanding the idea of shareholder control, our approach would also expand the application of shareholder fiduciary duties in a second fashion, by applying the duty of loyalty to any corporate transaction or strategy that provides one or more shareholders with a material, personal pecuniary benefit not shared by other shareholders. This approach rejects any claim that shareholder conflicts of interest arise only in freeze-outs and closely held corporations.... Rather than trying to identify isolated instances in which shareholder conflicts arise, our approach instead asks the larger question ...: Does the shareholder have any material economic interest, in any form, that is different from other shareholders' interests in the matter?

We would also incorporate another important aspect of conventional loyalty doctrine into our proposed expansion of shareholder duties, the principle that a conflict of interest can exist not only when a shareholder causes the corporation to pursue a transaction or strategy that clearly and affirmatively harms the corporation or other shareholders but also when the controlling shareholder uses his power over the corporation to promote a transaction that does not result in obvious harm but provides the controlling shareholder with a personal benefit that is not shared with other shareholders.

Incorporating Traditional Loyalty Defenses

On first inspection, the suggestion that all shareholders should be subject to a latent fiduciary duty of loyalty might lead a casual observer to conclude the natural result will be an explosion of litigation. This is not the case. The practical scope of loyalty duties can and should be contained, and litigation should be confined to cases presenting real and serious conflicts of interest, through several restrictive measures. One of the most important is to allow shareholders accused of breaching their duty of loyalty to use the procedural rules and affirmative legal defenses employed in cases involving officers and directors accused of breaching loyalty duties. These procedures and defenses have proven effective at discouraging frivolous litigation in that context, and there is no readily apparent reason to believe that they would not be similarly effective at protecting shareholder defendants from frivolous litigation as well.

It should be noted that the requirement that the plaintiff allege facts showing a material benefit not shared by other shareholders presents an obstacle to the use of shareholder fiduciary duties to address conflicts between short-term and long-term shareholders. To show that an activist investor was subject to such a conflict, a plaintiff would have to show that the investor had either already sold its interest, or intended to sell it in the very near future. The plaintiff would also have to show that the stock price increase resulting from the activist's efforts was only temporary, and so did not equally benefit long-term shareholders. We acknowledge that it will be difficult to make such a showing in most cases, as the temporary nature of the price increase will become apparent only after some time, and then any decline could be attributed to other causes. Thus, the expanded shareholder fiduciary duty we propose may prove more difficult to employ against conflicts of interest due to investors' differing time horizons than to other shareholder conflicts of interest.

[T]he case for loyalty duties may be even stronger in this [shareholder] context [than in the directors' and officers' context—Ed.]. Misbehavior by officers and directors is constrained by other powerful forces, above and beyond the threat of liability, that do not apply nearly as strongly to minority shareholders. For example, reputational concerns that might discourage an executive or board member from entering a

blatantly self-interested transaction are far less likely to dissuade a hedge fund investor. Not only is a hedge fund manager's reputation unlikely to suffer as a result of grasping behavior, he may even be rewarded for it by his own investors, who stand to profit from it. The market for corporate control is similarly unlikely to deter minority shareholders from behaving opportunistically. Whereas managers who steal from their firms risk being ousted, activist shareholders who indulge in self-dealing do not face this risk. Thus, fiduciary duty rules may be even more important in the shareholder context than they are for managers.

[An] objection some might raise to our proposal is that it is simply unnecessary because non-controlling shareholder overreaching is limited by the principle of majority rule. According to this argument, minority shareholders cannot pursue private agendas to the detriment of other shareholders because they are unable to obtain the support they need to push through their initiatives. For example, a union pension fund opposing a sale of the company out of fear it will eliminate jobs will have trouble garnering support from other shareholders to veto the deal. Only activist initiatives that increase shareholder value should succeed.

There are a number of difficulties with this argument. Most centrally, it ignores that fact that the same rational apathy that makes it difficult for public company shareholders to police managers makes it difficult for them to police each other. To oppose an overreaching activist, other shareholders must first know about the overreaching; then, they must be able to take action to prevent it; and, finally, they must overcome the free-rider problem that tempts each to sit back and hope another shareholder will do the work.

Each of these requirements is problematic. Activists rarely go out of their way to publicize their conflicts of interest. To the contrary, they try to obscure them, and their disclosure obligations are often partial at best. This makes it difficult for unconflicted shareholders to obtain information about activists' real motives, even should they be inclined to do so. Second, it can be difficult even for informed shareholders to prevent an activist from pushing through a corporate strategy or transaction that does not require a shareholder vote. For example, activists can apply pressure directly to managers to pursue business policies that favor their private interests, with other shareholders having no say in such decisions. Finally, free riding is an endemic problem. Even when a disinterested shareholder, such as a large mutual fund, holds a large enough block of shares to make it economically worthwhile to oppose an overreaching activist, the mutual fund may well decline to do so in the hope another large mutual fund may step in. None of this is to say that majority rule cannot be a serious impediment to minority shareholder "rent-seeking." But it is hardly a panacea. Ample room remains for expanded shareholder fiduciary duties to curb shareholder self-interested behavior.

The Promise and Peril of Corporate Governance Indices*

SANJAI BHAGAT, BRIAN BOLTON and ROBERTA ROMANO

Today, a market for corporate governance ratings exists, with proxy-advising firms—such as the dominant market leader, Institutional Shareholder Services, Inc. (ISS) [now known by its acquirer's name, RiskMetrics Group—Ed.]—using ratings to formulate voting recommendations and other governance-rating providers using them to advise on investment decisions.

The idea underlying ratings construction is to benchmark a firm's governance features against what the index constructor considers to be best practices. Accordingly, a firm's score on the index or rating is intended to provide a readily comparable, summary measure of governance quality.

Aggregated Measures of Corporate Governance: Governance Indices

The corporate governance indices that are currently in use by academics and commercial vendors vary considerably with respect to which features of firms' corporate governance are deemed sufficiently important to be included. The initial foray into creating an index was an academic inquiry. But the line of research rapidly generated commercial products that are marketed primarily to institutional investors seeking information about the quality of firms' corporate governance, as well as to firms wishing to signal governance quality to investors.

Gompers, Ishii, and Metrick's G–Index

The creation of firm-level corporate governance indices began with Gompers, Ishii and Metrick's (GIM's) research, which was published in 2003 but widely circulated in 2001. GIM constructed their index from data on the governance characteristics of over 1,000 firms, including most large public corporations (the Fortune 500 and Standard & Poor's 500), compiled by the Investor Responsibility Research Center (IRRC), a nonprofit research group that served institutional investors. Because IRRC's clients had become active in corporate governance in order to oppose takeover defenses in the 1980s, most of the governance features tracked by the IRRC are defensive tactics. The features consist of 22 provisions in firms' corporate documents (17 of which are takeover-related) and six types of state takeover statutes, resulting in 24 distinct items.

GIM added up the number of provisions that each firm had of the 24 items, assigning one point for each provision that they viewed as restricting shareholder rights, and one point for the absence of either of

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